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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/35

10:00 a.m., March 17, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	T. P. Thomas, Temporary
Zhang M.	Wei B.
T. C. Dawson	J. M. Abbott, Temporary
J. de Groote	J. Prader
	S. M. McDougall, Temporary
I. Fridriksson	
	N. Tabata, Temporary
J. E. Ismael	K.-T. Hetrakul
D. Kaeser	R. F. Cippa, Temporary
	P. L. Rubianes, Temporary
	A. Mohzin
	A. Vori, Temporary
	I. Martel
	D. Desruelle, Temporary
	G. Torres
	A. Galicia, Temporary
A. Mirakhor	M. Hammoudi, Temporary
	T. Berrihun, Temporary
D. Peretz	J. Dorrington
G. A. Posthumus	O. Havrylyshyn
	A. R. Ismael, Temporary
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
	G. F. Murphy
	K. J. Langdon, Temporary
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

IBRD: N. Shafik and R. M. Coutinho, Europe and Central Asia Regional Office. European I Department: M. Russo, Director; M. C. Deppler, Deputy Director; B. Banerjee, G. Bélanger, P. Doyle, L. P. Ebrill, S. G. Lipworth, M. Mrakovcic, J. F. van Houten, E. J. Zervoudakis. Fiscal Affairs Department: F. C. Ribe. Legal Department: P. L. Francotte. Policy Development and Review Department: T. Leddy, Deputy Director; M. A. Da Costa, M. G. Gilman, R. T. Harmsen, Y. Okubo, A. Singh. Secretary's Department: A. Leipold, A. Mountford. Treasurer's Department: A. W. Lake. Personal Assistant to the Managing Director: G. R. Saunders. Advisors to Executive Directors: M. B. Chatah, S. K. Fayyad, G. Y. Glazkov, P. A. Merino, R. Meron, B. Szombati, A. Törnqvist. Assistants to Executive Directors: H. M. Al-Atrash, S. E. Al-Huseini, D. A. Barr, G. M. Blome, Duan J., M. E. Hansen, J. Jonas, R. Kibria, T.-M. Kudiwu, V. Kural, S. K. Regmi, S. Shimizu, R. Thorne.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Zhang to the Executive Board as Executive Director for China.

2. CZECH REPUBLIC - STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the Czech Republic's request for a 12-month stand-by arrangement in an amount equivalent to SDR 177 million (EBS/93/27, Sup. 1, 3/2/93). They also had before them the authorities' letter of intent (EBS/93/27, 2/19/93).

Mr. de Groote made the following statement:

> Anyone familiar with Czechoslovakia's exceptionally good performance over the past two years under Fund stand-by arrangements might wonder why the Czech Republic, one of the most successful transition countries, should now be requesting a new stand-by arrangement. The reason is simple: the Fund's support under stand-by and other arrangements is both financial and moral, and the catalytic benefits of such support are the primary object of the present request.
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> As expected, the "velvet divorce" of Czechoslovakia at the end of 1992, even though accomplished in a constitutional and civilized manner, aroused considerable uncertainty. Particularly disquieting was the fact that, despite strong efforts to postpone the dissolution of the Czech and Slovak monetary union, it was ended much sooner than planned, surviving Czechoslovakia by only five weeks. Its replacement by a payments agreement providing a temporary clearing mechanism, which will allow trade to continue despite the shortage of hard currency in the Slovak Republic, could not by itself restore credibility. Last November, referring to the impending Czechoslovak partition, I said that "the media have approached this unusual process with their usual expectation of finding negatives in novelty. Their pessimism owes more to habit than to observation." This statement has lost none of its force in the time since then.
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> Market nervousness following the separation of the currency put a deep dent in the foreign currency reserves of the Czech National Bank. Although this drop in reserves was only temporary, my authorities now consider it prudent to ward off any possible doubts about their continuing commitment and ability to pursue strong macroeconomic and structural policies. They believe the best way of signaling to the markets that they are continuing to follow such policies is to sign a new stand-by arrangement with the Fund. It is clear from the terms of purchases and repurchases of the new arrangement that its main purpose is not financial but

catalytic. Such an arrangement would have been even more useful if it had been approved the week after the currency separation. This was obviously not possible. Even so, the authorities' announcement that they intended to negotiate an arrangement has already by itself been helpful, as shown by the most recent developments in both the external and domestic sectors.

The most recent data indicate that the Czech Republic will have no problem maintaining its external viability. The Czech National Bank's official foreign reserves have already recovered from their low of $463 million at the beginning of February 1993 to about $1 billion today. The end-1993 reserve target of $2 billion thus seems realistic for the following reasons. First, the Czech National Bank has been very successful in maintaining its access to the international financial markets; last week, it sold $300 million in three-year bonds with interest rates equal to U.S. Treasury rates for bonds of similar maturity plus 272 basis points. This issue sold out in a single day, and the high demand prompted them to extend the issue by an additional $75 million. Perhaps in response to this success, Moody's Investor Service has increased its rating of the Czech Republic's debt from BA1 to BA3, which means that it is of investment grade now. It is now understood that additional placements will be possible if they are required. Because the National Bank expects its debt rating to improve still further when the Czech Republic's good performance receives backing from closer integration into European economic and political structures, it prefers shorter-term bonds. If we add the proceeds from the bond issue to official foreign reserves, they would now amount to over $1.3 billion.

The second reason why the end-1993 reserves target is realistic is that the National Bank is again accumulating official reserves from the interbank foreign exchange market, the so-called fixing market. The National Bank, which was a net seller of foreign currencies prior to the ending of the monetary union, has since then become a net buyer on this market as the commercial banks completed their desired foreign currency holdings. A third reason is the continued injection of inflows from foreign direct investment, most recently Phillip Morris's acquisition of shares in the tobacco industry.

In the domestic sector, the most important development is the decline in inflation. The consumer price index fell from 8.5 percent in January, after introduction of the value-added tax (VAT), to 1.3 percent in February. In March, a further decrease is expected to levels consistent with the 1993 target of 15-18 percent. The General Agreement signed last week between the Government, trade unions, and employers provides a sufficient guarantee that wage growth will not become a source of inflationary pressures.

The government budget is performing well so far, despite concern about the possibility of a revenue shortfall due to the introduction of the new tax system. For February and the beginning of March, the budget still shows a small surplus, but it is too soon to make a definitive guess about the impact of the new tax system on the budget.

For the near term, another source of uncertainty about the Czech economy lies in its trade with the Slovak Republic. The two most noticeable indications during the first weeks of this year were the decline in the total volume of inter-Republic trade in January, down 40 percent from last year, and the persistence of the Czech Republic's large trade surplus even at this lower volume of trade. In the first few weeks of the payments union, the Slovak Republic's trade deficit rose nearly halfway to the ECU 130 million ceiling on trade credit provided by the Czech Republic under the payments agreement. The Slovak Republic has already effected the 5 percent maximum devaluation of its currency against the clearing ECU allowed under the payments agreement, and the Czech Republic has revalued its currency by 2 percent, but the effects of these measures on the trade balance are not yet clear.

For this reason, the Czech authorities are considering various measures aimed at avoiding further accumulation of trade credit to the Slovak Republic while ensuring that trade does not collapse. These measures include revaluing the Czech currency against the clearing ECU by the additional 3 percent available under the payments agreement, encouraging Czech exporters to shift to the use of payment instruments that protect their receivables, supporting the initiative of the European Bank for Reconstruction and Development for stabilizing Czech-Slovak trade, and discussing with the Slovak Government cooperative measures for stimulating Slovak exports and improving the payment record of Slovak importers. At the same time, the Czech Government is urging Czech exporters to accept barter trade with Slovak partners only on an exceptional basis.

On balance, the greatest threat to a Czech economic revival during the next few months is the possibility that Czech trade with the Slovak Republic will continue to decline. However, even under the most pessimistic trade scenario, a continued decline would only delay--but not derail--the expected recovery of the Czech economy. In the coming months, the individual investors and investment funds that became owners of shares during the first wave of voucher privatization will begin to exercise their ownership rights, and a second wave of privatization has been announced for mid-1993. The strong private sector that will, therefore, soon exist will provide the best guarantee for a successful Czech economic performance in the future.

> The history of economic reform in Czechoslovakia over the last two years, and in the Czech Republic from the beginning of this year, is a striking example of how the Fund can assist countries by providing both moral and financial support for a convincing adjustment program. For Czechoslovakia, the Fund's support was especially critical at a moment when it was still unclear to many observers whether the so-called shock therapy strategy, consisting of simultaneous rapid movement toward both economic stabilization and structural reforms, would really work. It did work, and I would like to take this opportunity to say again how much my authorities appreciate their excellent partnership with the Fund. The strength of this dialogue is once more demonstrated by the expeditious completion of the negotiations for the present stand-by arrangement request, and by the Board's willingness to examine it on very short notice. I can assure my colleagues that the Czech Government will continue to implement policies that will deserve the confidence of the Board.

The Chairman said that he was pleased that Mr. de Groote's statement referred to the expeditious completion of the negotiations for the current stand-by arrangement and to the Board's willingness to examine the authorities' request at very short notice. The speed and flexibility of the Fund's response, which had contributed to the early turnaround that was reported by Mr. de Groote, was especially gratifying.

The possibility of Fund support for the policies of the Czech Republic had first been discussed in general terms by the Deputy Managing Director and Prime Minister Klaus in Davos, Switzerland, in late January 1992, the Chairman noted. On February 4, a request to discuss the possible use of Fund resources had been received by management, and a negotiating team had been sent to Prague within a matter of days. Those discussions had been concluded successfully on February 12, and the letter of intent had been signed on February 18. The staff paper for the present meeting had been issued on March 2. In total, therefore, less than six weeks had elapsed since the authorities' initial request.

The rapid speed of the Fund's response had clearly been warranted by the nature of the shock, its unknown magnitude, and the crisis of confidence faced by the Czech Republic despite the continued pursuit of strong economic policies over the previous two years in close collaboration with the Fund, the Chairman considered. The Fund had worked quickly and flexibly within its usual procedures, as a result of its familiarity with the strength of the authorities' policies, while maintaining all of the normal safeguards. He was grateful for the appreciation of the authorities, and he looked forward to being in a position to react promptly and effectively in other such cases in the future.

Mr. Havrylyshyn made the following statement:

Let me at the outset express my strong support for the request of the Czech authorities for a stand-by arrangement. I fully agree with its justification as stated in the statement by Mr. de Groote, namely, the catalytic role it will play for the Czech economy. Indeed, I consider it a commendable initiative on the part of staff to use a stand-by arrangement for the purpose stated: building up reserves from a low level.

The strong achievements in the macroeconomic stabilization and structural fields under the previous stand-by arrangement with Czechoslovakia are convincing evidence of the authorities' commitment to the reform measures. The tight monetary and fiscal policies envisaged in the program, aimed at keeping inflation under control and creating conditions for an increase in economic activity, are an illustration of this continued commitment. The budget deficit projected for 1993, at 1 percent of GDP, is not large enough to be of concern, but I fully agree with the staff that the authorities should be prepared to address any imbalance due to either the introduction of the VAT or unexpected expenditures that could have an adverse effect on budget developments, the level of reserves, or the lowering of inflation. In this respect, I welcome the authorities' policy of keeping wage increases in line with labor productivity and within the inflation limit.

My only concern after reading the staff paper relates to the envisaged operation of the bilateral payments arrangement, which has replaced the monetary and currency union with the Slovak Republic. The first indications about Czech and Slovak trade in the framework of this arrangement, according to Mr. de Groote's statement, seem to confirm this concern. The high degree of interdependence of the two economies, on the one hand, and these disappointing developments, on the other hand, make me wonder whether the very early restoration of a viable balance of payments and reserves position estimated by the authorities--end-April or early June 1993--is not too optimistic. Let me make it clear: I have no doubt at all about the achievability of these targets. However, I wonder whether, given the latest data on Czech-Slovak trade, it would be more realistic to expect their achievement not in two to three months but in five to six months, and thus avoid possible waiver requests. Staff comments in this respect would be very useful.

Let me conclude by joining the Chairman in noting that the approval of the authorities' request will demonstrate how quickly the Fund can react in the face of a real need of a country whose policy is solidly and well formulated.

Mr. Dawson made the following statement:

The Czech Republic's vigorous pursuit of sound macroeconomic policies and rapid structural reform prior to January 1, 1993 has put the new country in a favorable position at independence, notwithstanding some understandable uncertainties surrounding the dissolution of the federation. Indeed, indications that the decline in output has stopped, that inflation continues to decelerate, that the 1992 fiscal position, excluding transfers to the Slovak Republic, was in small surplus, that the current account was in balance, and that foreign direct investment gathered steam for much of last year augur well for further stabilization and the resumption of growth.

We agree that the challenge now is to dispel any lingering doubts about the direction of Czech policies following dissolution and the country's ability to withstand possible additional strains emerging from the Slovak Republic. In this connection, we believe that the authorities have been very wise to seek an arrangement with the Fund. In addition to giving an initial boost to reserves, a Fund-supported program should go a long way toward reassuring any remaining doubters of Czech policy or resolve. Moreover, if, in fact, developments unfold as expected, the Czech Republic may find itself in the unusual position of obtaining two seals of approval for one program: the first for having a Fund program in the first place, and the second for demonstrating that it no longer needs the Fund's resources by effecting an early repurchase.

In our view, the program appears to be well designed to build upon the stabilization gains so far and to adjust to adverse developments, should they arise. On the fiscal side, we welcome the structural changes under way in the tax area, such as the move from a turnover tax to a VAT, the rebalancing of the burden of social security contributions, combined with the reduction in personal income tax, and the removal of the import surcharge. It is also encouraging to see some decline in the amount of government expenditure as a share of GDP, and we would urge the authorities to continue reducing what we see as a rather large share of national resources absorbed by the public sector. Presumably, further privatization will hasten this decline.

Given the uncertainties about government revenue collections, the authorities are to be commended for their commitment to contain quarterly spending below budgeted amounts in the first part of the year and for their readiness to take additional measures, as needed. With fiscal policy as the bellwether for the authorities' policy credibility, we urge particular vigilance in this area.

The dissolution of the federation had a particularly disruptive effect on monetary policy, but we are pleased to see that the authorities have moved quickly and effectively to curtail liquidity. Early indications of a decline in inflation and an increase in reserves suggest that the authorities are already well on their way to achieving their monetary policy goals. However, we welcome the assurances that the Fund and the authorities will keep in close contact in the coming months, especially as regards the possible need for further adjustments in the monetary stance.

While the adoption of a Fund-supported program will go a long way toward reassuring the markets and foreign investors, policy credibility, not to mention growth and employment, will also hinge importantly on continued structural reform. In this connection, we believe that it will be particularly important for the authorities to proceed with the "second wave" of large-scale privatization on schedule.

We also look forward to the implementation of bankruptcy legislation. The amendment to this legislation, which appears to be akin to the U.S. "Chapter 11" protection, is a constructive addition. However, we hope that the authorities will proceed with bankruptcy proceedings expeditiously in cases where companies cannot be successfully reorganized. We also hope that the opportunity provided for the Consolidation Bank or State Bank to intervene in the process for strategic or other reasons will not be used frequently. We also hope to see further progress on increasing efficiency and competition in the financial sector, perhaps through splitting up the near monopoly positions of the largest commercial and savings banks.

Turning to the external sector, we agree that the Czech Republic's fixed exchange rate system has served it well. This is, of course, in keeping with this chair's position of flexibly supporting different exchange rate systems as long as they are supported by appropriate economic policies. However, in using the exchange rate as a nominal anchor, the authorities will have to be particularly vigilant that domestic prices decelerate and wage settlements remain moderate so as not to undermine competitiveness. As regards trade with the Slovak Republic, I must say I share Mr. Havrylyshyn's concerns about the bilateral clearing system, and I would appreciate the staff's or Mr. de Groote's comments on how long it is likely to last.

In conclusion, we fully support the Czech authorities' request for a stand-by arrangement and look forward to an early review of their performance.

Mr. Schoenberg made the following statement:

I fully support the Czech authorities' request for a stand-by arrangement and the proposed draft decision to comply with that request. The staff and management are to be commended indeed for their speed and flexibility in reacting to the needs of a member country in this case.

The reasons for the Czech Republic to draw again on the Fund, in spite of the excellent track record of Czechoslovakia, are convincingly explained in the staff paper and in Mr. de Groote's statement, and they merit support. Indeed, the aim of securing not only the financial but particularly the moral support of the Fund in times of far-reaching economic changes and risks surrounding the division of the country is an excellent example of a member making optimal use of what the Fund can offer in terms of the catalytic benefits associated with its involvement.

In view of the good performance of the Czech authorities under the 1992 program, the impressive record of success in structural adjustment, particularly in the domain of privatization, and the authorities' intention to continue economic reform in close cooperation with the Fund, there are strong reasons to grant the authorities the confidence and trust they deserve. Since we are in broad agreement with the staff appraisal, I will limit myself to a few brief remarks.

Concerning fiscal policy, I share the staff's view that the budget should be kept as close to balance as possible. In this regard, it might be prudent to curb temporary current expenditures until the difficulties associated with the collection of new taxes have been overcome. While welcoming in principle the fact that the authorities are ready to take additional measures before the middle of the year in case of unfavorable revenue developments, I would be interested to learn from the staff what concrete measures are envisaged in such a situation.

As to monetary policy, the inflation targets are not excessively ambitious, even if the VAT-induced price jump is taken into account. Consumer prices are expected to rise by 18 percent on average in 1993, compared with 11 percent in 1992. In the absence of a major fiscal imbalance, inflation in the Czech Republic is largely a monetary phenomenon. The relatively strong increase in broad money, 17.5 percent, which is projected to grow at least six times as fast as real GDP, is a particular cause for concern. In view of the staff's conclusion that "a significant share of the burden of achieving a rapid rebuilding of credibility and confidence falls upon monetary policy," I wonder whether a further tightening of monetary policy might not be appropriate, and perhaps even necessary, in order to avoid large exchange rate changes vis-à-vis convertible currencies.

It is also debatable whether the structure of interest rates is already adequate. Table 1 in the staff paper gives the impression that household savings deposit rates were considerably negative in real terms in 1991 and 1992. Would the staff agree that this would indicate a need to raise interest rates? An increase in the level of interest rates, to be brought about, inter alia, by restraining commercial banks' refinancing capacity, might also induce a return of the capital that had left the country prior to the dissolution of the federation.

With regard to wage policy, I have the impression that the Government's wage guidelines and the recent agreement run the risk of leading to a de facto indexation of wages, even if explicit wage indexation is avoided. While recognizing that wage indexation would enhance public support for further structural adjustment, I still wonder whether this policy is appropriate in view of the objectives of maintaining external competitiveness, defending the exchange rate peg, and reducing inflation. In sectors where industry has not yet achieved external competitiveness, a reduction in real wages should not be excluded.

Concerning the area of structural reform, I would like to underline the desirability of an early implementation of the long-delayed bankruptcy legislation. In this context, I would welcome staff comment on the amendment of the bankruptcy law that has been tabled recently, which serves the purpose of creating a breathing space of three months for insolvent enterprises. Should this be seen as an improvement? While such a breathing space may provide an appropriate opportunity for the state to consider intervention, it could also contribute to undue delays or even the prevention of necessary bankruptcy procedures.

With these observations, I can support the proposed decision.

Mr. Peretz made the following statement:

In his statement, Mr. de Groote suggests that we might wonder why the Czech Republic is requesting a stand-by arrangement after the very strong performance in its transition to a market economy. I would look at it in a different way. I think what we are looking at today is not another program for an economy in transition; rather, we are looking at something that is closer to a classic stand-by arrangement, intended to restore confidence in what is clearly a temporary period of uncertainty following the partition of the federation into two countries.

Like other speakers, I welcome the speed with which the Fund has moved in this case. Like Mr. Dawson, I look forward to a second seal of approval soon when the authorities are able to undertake an early repurchase. Meanwhile, I imagine the success of last week's bond issue can be attributed in part to the confidence that has already been restored by the prospects of an agreement on a stand-by arrangement with the Fund and by the letter of intent.

The short-term nature of the assistance rests, as the staff recognizes, on the underlying strength of the Czech Republic's economy and particularly, as other speakers have pointed out, on continued trade with the Slovak Republic. In this respect, I am concerned that the staff estimates may be a little on the optimistic side. The staff forecast of 1-3 percent growth this year contrasts with the forecast by the Institute for Economic Policy of a decline on the same scale, with worries that sluggish investment may dampen the revival in the Czech Republic. I also believe that the Czech central bank has estimated a 30 percent fall in inter-Republic trade, rather than the 10-15 percent decline estimated by the staff.

A further uncertainty relates to the radical revision of the taxation structure. Experience with other countries in transition certainly confirms that very radical changes in tax structure are needed if revenue is to be maintained as activity shifts from the public to the private sector. I suspect that other economies in transition may have something to learn from the Czech experience. On the other hand, with such a change, the short-term effects are clearly very uncertain, and I can well understand that it will be impossible to assess properly the effects until the middle of the year. Therefore, I welcome the proposed early review of the arrangement at that stage, and I welcome the authorities' indication that they would be ready to take offsetting measures if necessary. Perhaps the staff could indicate whether it had discussed with the authorities the kind of measures that might be taken, if they were necessary.

On government spending, I note the efforts to institute controls, which I certainly hope are at least as rigorous as were the controls in the former federation. I recall, though, that monthly control totals were set in the final part of last year, whereas the Czech Republic has now set quarterly totals. Perhaps the staff could comment on whether these new controls are as strong as those established prior to the dissolution of the federation, and whether permanent measures are now in place to repeat the achievement in 1992 of avoiding an end-year spending rush.

Given the importance that the authorities place on their exchange rate peg, nominal wage restraint is clearly very important. It had been a goal of the federal authorities last year to keep real wages constant, but I note that, in fact, they rose by 8 percent. I see that the Czech authorities have set a similar goal for this year. Given the rising levels of unemployment--and I suspect that the projection of 7.5 percent unemployment may be a little optimistic--the authorities were certainly right to have resisted wage indexation, but it will also be important to devise measures to replace direct wage controls as soon as possible. The fact that competitiveness performance in recent years has been good is no reason for complacency in this area.

Finally, let me turn to the subject of the separation of currencies. I was slightly surprised to read in the staff paper that the staff attributes the decline in official reserves, which immediately preceded the dissolution of the federation, to the reconstitution of commercial banks' foreign assets to meet supervisory requirements. Certainly, reports at the time had suggested that the decline in the willingness to hold common currency bank notes was, in fact, a major factor leading to the depletion of official foreign exchange reserves. Obviously, in the circumstances, the authorities' decision to raise reserve requirements to mop up the excess liquidity caused by banks' higher holdings of domestic currency was a sensible response to a presumably temporary phenomenon. I hope that they will be equally ready to presumably lower the reserve requirements again as and when necessary, while, of course, retaining appropriately tight monetary conditions through interest rate policy.

The overall experience of currency separation demonstrates once again that the best-laid official plans on such matters can easily be overtaken by market events, but that, with an appropriate response from the authorities, public panic and disruption can be avoided, as they were in this case.

My best wishes to the Czech authorities consist essentially of wishing them a period of economic development that will seem rather dull and uneventful compared with the events of the last few months and years.

Mrs. Martel made the following statement:

Obviously, this is a most welcome program, and our institution is especially commendable for coming to the support of the Czech Republic so soon after its independence. Clearly, the very good track record of Czechoslovakia has enabled the Fund to move quickly in establishing the basis for future stabilization and growth in the Czech Republic. Nevertheless, the fragile situation of international reserves at independence posed a threat to the whole stabilization program. Therefore, we certainly approve the proposed decision, and I will limit myself to making a few comments.

First, as explained by Mr. de Groote in his statement, the main rationale for the present arrangement is both financial and moral. It is crucial in this period of transition that the Fund be seen as supporting the newly independent Czech Republic, whose policies are very much in line with those that had been implemented previously in Czechoslovakia. This is especially true as far as reconstituting foreign reserves is concerned. In this period, the front-loading of purchases is certainly welcome, inasmuch as it will contribute to strengthening confidence in the ability of the Czech Republic to defend its exchange rate and, more generally, its policies. In the same spirit, I could have supported a higher level of greater access, although the data presented by Mr. de Groote in his excellent statement show that the recovery in reserves might occur even faster than expected.

Second, I agree that the main downside risk in the present circumstances is a collapse in trade between the Czech and Slovak Republics. Neither Republic needs, at this stage, the further shock and impediments to growth that a collapse in trade would represent. All of the possibilities offered by the present clearing agreement should certainly be explored, but I would welcome an indication of the further action that could be taken, with the cooperation of our institution, if the situation were to deteriorate further.

Third, although inflation is receding, the Czech Republic can keep its excellent record on this front only through continued and constant vigilance. There seem to be signs, in this regard, of new fragility in wage policy. As acknowledged by the authorities, pressures are increasing for explicit wage indexation. Of course, if this were to happen, the possibility of maintaining a stable exchange rate policy would be greatly undermined. It is also to be expected that those pressures will grow stronger if inflation is not brought down quickly. Therefore, it is all the more important that fiscal policy should be conducted with the necessary rigor, and I strongly agree with the staff's recommendation that the budget should be kept as close to balance as possible in order to strengthen the credibility of government policy.

Finally, it is especially remarkable that, even in this transition period, the Government is pursuing with determination its program of structural reform and privatization. The results achieved so far are significant, and the pursuit of the voucher program should enable the Czech Republic to take a decisive step toward establishing all of the bases for a market-oriented and successful economy.

Mr. Tabata made the following statement:

I was impressed by the Chairman's explanation of the negotiation process for this stand-by arrangement. I would also like to express my appreciation for the quick response of management and the intensive efforts of the staff.

The most urgent task for the authorities is to reduce the uncertainty caused by the dissolution of Czechoslovakia and, at the same time, re-establish confidence in the authorities' implementation of economic policies. I believe this stand-by arrangement will support the Czech Republic's smooth transition to a market economy.

In general, the Czech Republic's economic performance has been favorable. It is expected that the Czech Republic will have a balance of payments surplus in 1993. Moreover, reserves, which had decreased dramatically, have already recovered to approximately $1 billion. In addition, it is encouraging that the National Bank has succeeded in issuing more than $300 million in bonds in the Euromarket. Given the fact that the authorities do not intend to make a second purchase, that they intend to make an early repurchase before the end of the year, and that the track record of Czechoslovakia under the previous stand-by arrangement was favorable, I can endorse the Czech authorities' request for a stand-by arrangement.

Regarding fiscal policy, the budget deficit as a share of GDP is projected to be 1 percent this year, which is an excellent figure for a transition economy. Further increases in the deficit should be avoided. In this regard, one source of concern is whether the VAT, which replaced the turnover tax this year, will generate substantial revenue. Therefore, the authorities should make every effort to strengthen tax administration. In any event, the authorities are urged to monitor developments carefully and take additional measures whenever necessary. Needless to say, such additional measures should include a cut in current expenditures, such as subsidies.

On monetary policy, it is commendable that the authorities' successful control of monetary aggregates and liquidity reduced inflation and inflationary expectations. Looking ahead, the balance of payments position is expected to be strong, and as confidence is restored, short-term capital could reflow into the economy. In that case, cautious implementation of monetary policy is expected. In this context, I appreciate the measures already taken by the authorities, such as raising the discount rate, restricting refinancing, and increasing the reserve requirement ratio.

The tax-based incomes policy worked relatively well to reduce inflation, avoid the wage spiral, and strengthen external competitiveness. It is, therefore, a matter of concern that wage controls were abolished and that the pressure to introduce indexation is increasing. I expect that a cooperative relationship between entrepreneurs and workers will be established and, at the same time, that flexibility of the real wage will be maintained.

At the previous discussion on the review of Czechoslovakia's stand-by arrangement (EBM/92/137, 11/16/92), I stated that EC countries should abolish the restrictions on iron and steel imports from Czechoslovakia. I would be interested to learn from Executive Directors for EC countries what their countries' policy is on this matter.

Let me comment briefly on structural policy. I welcome the fact that the first wave of large-scale privatization was successfully completed. This is one of the main reasons why the economy has maintained its stability. Therefore, I strongly urge the authorities to proceed with privatization as planned. In this connection, implementation of bankruptcy legislation is all the more important.

Finally, the Czech Republic has been the best example of a successful transition to a market-oriented economy, and I expect that it will continue to be the best such example among the economies in transition.

With these remarks, I support the proposed decision.

Miss Vori made the following statement:

The Czech Republic continues to make progress in the transition toward a market economy. The shock of the dissolution of Czechoslovakia appears to have been absorbed with no major disruptions; meanwhile, the program of structural reform has been expedited, and the first round of privatization has been successfully completed. The quick pace of recovery relative to other transition economies was made possible by the fact that the country inherited a comparatively favorable position, with no major imbalances that required strong corrective actions. Still, important challenges lie ahead for the Czech authorities.

I understand the rationale for the Czech authorities' request for a stand-by arrangement as a means to quickly restore confidence in their firm policy stance and rebuild credibility. In this sense, I agree with Mr. de Groote's definition of Fund support to the Czech Republic as "both financial and moral," and I appreciate the speed and flexibility of the response of the staff and management to the authorities' request. I will address a few issues that the authorities need to take into account in their attempt to quickly rebuild their credibility and ensure the consolidation of their reform efforts.

The most important issue of concern is the fiscal budget. The authorities' forecast of a deficit of 1 percent of GDP might turn out to be a bit optimistic for the following reasons. On the revenue side, the projected increase in indirect taxes is likely to be hampered by collection lags in the administration of the newly introduced VAT. On the expenditure side, social security transfers may be affected by the projected rise in unemployment as privatized enterprises start to lay off excess labor. Moreover, there is some uncertainty about the amount of bad loans in the banking system; a coordinated strategy linking the cleaning up of banks' balance sheets to their recapitalization and eventual privatization needs to be set up. The cost of such a program to be sustained by the fiscal budget may turn out higher than expected. Some comments from the staff on this issue would be welcome.

The success of the inflation stabilization strategy is strongly dependent on the authorities' commitment to a restrained fiscal policy. The authorities have correctly stressed their intention to stand ready to take contingent measures, should the need arise, to avoid inflationary bank financing and ensure that domestic credit will be available for private sector investment. Furthermore, the authorities must be commended for correctly approaching the issue of fiscal harmonization with the neighboring Slovak Republic. They have worked out an agreement for introducing a similar reform of the tax system, thus avoiding the problem of fiscal competition deriving from the movement of labor from high taxing regions to high spending regions. However, similar coordination should take place on the expenditure side and, therefore, on the size of the budget deficit, given that a coordinated budget policy is crucial to avoid strains in the fixed exchange rate system between the two countries. Perhaps the staff or Mr. de Groote could comment on the prospects for the establishment of a mechanism for the harmonization of fiscal policies in the two Republics.

On the monetary side, the difficulties of achieving a smooth partition have been highlighted by the swift collapse of the monetary union, which was replaced by an agreement between the two central banks on a fixed exchange rate arrangement. However, given the present situation, a persistent undervaluation of the parity of the Czech currency in relation to the currency of the Slovak Republic would amplify the negative risks of widespread currency substitution for the conduct of monetary policy. The

Czech National Bank might find it increasingly difficult to distinguish between the demand for the national currency by residents and that by nonresidents; it would, therefore, become difficult to curb inflationary pressures deriving from the growth of domestic monetary aggregates. Strict cooperation between the two central banks would be required in order to identify and control the growth of monetary aggregates in the whole area and, if the decision is made, to ensure a smooth transition to the subsequent phase of separate movements of two national currencies.

The present commitment to the exchange rate peg could be undermined by competitiveness developments. Inflation, although very low compared with that in other transition economies, is still well above that in the Czech Republic's main industrial country trading partners. It is imperative for the authorities to watch wage dynamics closely. The recent pressures for explicit wage indexation must be resisted by ensuring that the wage guidelines specified in the budget law, linking wage increases to programmed inflation, continue to be respected. A restrained incomes policy will allow the country to reap the anti-inflationary benefits of the exchange rate strategy, stabilize inflation expectations, and strengthen the authorities' policy credibility.

With these comments, I support the proposed decision.

The staff representative from the European I Department said that it was very difficult to judge the sustainability of the payments arrangement with the Slovak Republic. The Czech authorities had indicated clearly in their letter of intent that they considered the arrangement to be temporary and that they intended to move to settlement on a convertible currency basis as soon as possible, although the timing of that move was very uncertain. It was clear that trade between the two Republics had declined sharply in January and February 1993, but it would not have been unreasonable to have expected an even greater decline in the early stages of post-dissolution relations. Indeed, it was possible that the decline in trade would be larger than the estimate of 10-15 percent that had been built into the projections for 1993. Ultimately, of course, it was the uncertainty surrounding Czech trade with the Slovak Republic that had led the staff and the authorities to decide that there should be a very early review of developments under the arrangement.

In that context, the staff representative continued, he did not agree with Mr. Havrylyshyn that the targets that had been built into the performance criteria for April and June 1993 were premature in reflecting the favorable developments that were expected in the Czech Republic. The recent increase in the reserves of the Czech National Bank reflected in part some large discrete transactions, such as payments by foreign direct investors and loans that had been contracted by the Czech Republic, but about half of the improvement in reserves reflected a broad-based strengthening of the balance of payments position through purchases by the Czech National Bank at the daily fixing with commercial banks.

The staff was not aware of a projection by the Czech National Bank of a decline in Czech-Slovak trade of 30 percent in 1993, to which Mr. Peretz had referred, the staff representative remarked. During its discussions with the authorities, the most pessimistic estimate for the decline in trade in 1993 had been 40 percent. The authorities' program was based on a decline of 10-15 percent; it remained to be seen how much trade would recover in subsequent months. As a rule of thumb, a 10 percent decline in exports to the Slovak Republic would result in a decline of GDP of about 1 percent in the Czech Republic. Therefore, the difference between the growth forecast prepared by the staff and that prepared by the Institute of Economic Policy could reflect different assumptions about the decline in Czech trade with the Slovak Republic. Moreover, the Institute forecast had been prepared in January 1993, before the very strong results of the fourth-quarter of 1992 had been known, especially for the construction industry. The staff estimated that, on a fourth-quarter to fourth-quarter basis, GDP had increased by about 2 percentage points in 1992.

The staff had discussed with the authorities certain concrete measures that might be considered to correct the budget if necessary, although those discussions were at a very early stage, the staff representative stated. The first line of defense would be to make use of the room that had been created in budgetary spending by keeping allocations below amounts that were consistent with the annual totals, as the Czechoslovak authorities had done in 1992. Other measures were under consideration, some relating to measures that could be taken, if needed, to control wage increases.

The staff did not feel that monetary policy was too loose, the staff representative commented, because monetary policy was consistent with a significant decline in the underlying rate of inflation from about 10 percent to about 6 percent between 1992 and 1993, adjusting inflation for the one-time adjustment of administered prices in both years and the introduction of the VAT in 1993. The monetary program was based on an unchanged velocity of money, which was a fairly restrictive assumption, given the increased intermediation that was taking place as part of the reforms; as had been the case in the other economies in transition, it would not be surprising if velocity were to decline during the period of transformation. The problem with the sharp decline of currency holdings in the Czech Republic had not been caused by an unwillingness to hold domestic bank notes, as Mr. Peretz had suggested, but by the fact that the household sector had been directed to deposit its domestic bank notes with the commercial banks in order to facilitate the currency separation and conversion.

Interest rates on savings were set freely by the commercial banks, the staff representative noted. There had been a strong increase in savings in Czechoslovakia, as had been the case in some of the other economies in transition. Interest rates on deposits varied depending on the term of the deposits; for medium- and longer-term deposits, interest rates were 11-13 percent on average, which was very close to the rate of inflation. The most important point, however, was that there had been a strong performance of savings by the household sector.

There had, indeed, been a change in wage policy, inasmuch as the tax on excessive wage increases had been removed, the staff representative said. The authorities' target was to maintain wages at their current level in real terms, although that approach was not a policy of indexation. The target for 1992 had also been not to have an increase in real wages; in the event, the increase in real wages in 1992 had reversed in part the very large decline in real wages in 1991. Nevertheless, competitiveness remained at what the staff considered an appropriate level, especially in terms of real unit labor costs, which, by the end of 1992, were still about 12 percent below the average for 1990. Export performance had also been quite satisfactory.

The staff shared the view of the authorities that the introduction of a three-month waiting period under the bankruptcy law was an improvement, in that it provided creditors and debtors with additional time to reach an agreement, the staff representative considered. The experience of Hungary suggested that there would, in any event, be a de facto waiting period, because it would be impossible for the courts to handle quickly all of its bankruptcy cases. Of course, it was important to be very careful about the extent to which the National Property Fund or the Consolidation Bank could become involved in bankruptcy proceedings.

It was true that the limits on spending had been set on a monthly basis for the last four months of 1992, although they had been set on a quarterly basis initially, the staff representative stated. The decision to set spending limits on a monthly basis had been intended to allow for much closer scrutiny of actual spending toward the end of the year, so as not to repeat the problems of 1991. For 1993, although the limits were set on a quarterly basis, monitoring would take place on a monthly basis, and the measures that had been in place in 1992 to control spending had been maintained.

There were at present no mechanisms for the harmonization of fiscal policy in the Czech Republic and the Slovak Republic, the staff representative from the European I Department said. To the extent that movements in fiscal deficits were inconsistent with the maintenance of exchange rate parity--notwithstanding the fact that there had already been a de facto depreciation of about 7 percent as a result of adjustments relative to the clearing ECU under the payments arrangement--it was clear that the stance of fiscal policy in one Republic could have policy implications for the other Republic.

Mr. Shaalan made the following statement:

This is the first opportunity that the Executive Board has had to comment on the economic policies of the Czech Republic since the dissolution of the federation. Allow me, therefore, to welcome its recent membership to the Fund. I am pleased to note that the underlying economic policies being pursued by the Czech authorities are broadly appropriate, and it is expected that the loss of reserves will be quickly halted and, indeed, reversed. Therefore, I have only a few comments on the paper before us.

I concur with the assessment that the state budget for 1993 of 1 percent of GDP does not appear to be too worrisome, and that it is important to identify measures that could be implemented at short notice in the event of adverse developments in the budget. Like Mr. Schoenberg and Mr. Peretz, I would have liked to see, in this regard, the identification of these additional fiscal measures in the paper, given the difficulties in the administration of the new tax system introduced on January 1, 1993, the possible disruptions to trade with the Slovak Republic, and the need to keep the budget as close to balance as possible. I would encourage the authorities to implement compensatory measures promptly in case of slippages that threaten the budgetary goal.

On the currency conversion that took place in early February 1993, I read with interest that the conversion rate between the currencies of the Slovak Republic and the Czech Republic was 1:1. I recall that the capital flight, which resulted in the Czech Republic's low level of reserves, was partly due to the expectation that the Slovak Republic's currency would depreciate vis-à-vis that of the Czech Republic upon the dissolution of the currency union; there was the expectation that capital flight would subsequently be reversed. Can the staff elaborate on speculative flows since the dissolution of the currency union and the appropriateness of the conversion rate in light of possible policy differences between the two Republics?

Finally, on incomes policy, like Mrs. Martel, I would urge the authorities to resist pressure for explicit wage indexation. Indexing wages to lagged inflation, particularly in an environment of major structural reforms and an anti-inflation policy, would have a detrimental impact on profitability and output and, therefore, on financial stability.

With these remarks, I have no problem in strongly supporting the proposed decision.

Mr. Fridriksson made the following statement:

I have little to add to this chorus of praise we have heard already, but, like others, I warmly support the Czech Republic's request for a stand-by arrangement and the impressively swift response of the Fund to the Czech Republic's request. By its determined and successful stabilization and reform policies, its predecessor, Czechoslovakia, has provided an excellent and encouraging example for other economies in transition. I am pleased to say that some of my authorities are closely studying and learning from the experience of Czechoslovakia and the Czech Republic.

It is particularly welcome to note that, broad macroeconomic stability having been achieved, the fall in output has now been halted and that positive growth is projected for 1993. This shows that consistently pursued tough policies, or "shock therapy," as it is referred to by Mr. de Groote, will produce the desired results.

The current problems of the Czech Republic are clearly not policy related, but result from a crisis of confidence caused by the separation of the Czech and Slovak economies, and particularly the separation of the currencies. Although it was a "velvet divorce," this event can be compared to a major structural shock. In this situation, quick action by the Fund to help restore confidence is most appropriate. The program presented in the letter of intent is strong and merits support. There is little doubt that the Czech Republic will continue along the successful path of its predecessor and be able to maintain external viability and meet its obligations to the Fund.

As the staff points out, however, the future development of trade with the Slovak Republic is an element of uncertainty that cannot be overlooked. It is, therefore, important that developments are followed closely and that a review is conducted early, as the staff suggests. I also agree with the staff on the crucial role of monetary policy in re-establishing confidence. The authorities will have to monitor developments in the monetary field carefully and be prepared to adjust policies quickly in response to any adverse changes.

Mr. Kaeser made the following statement:

This chair very much welcomes the peaceful partition of Czechoslovakia. This partition has been called a "velvet divorce." As everybody knows, velvet is a fabric with one soft side and one rough side. In this divorce, the Czech Republic is obviously on the soft side. It is in a very comfortable position: it has regained access to the international capital market, experienced a large capital inflow, and it does not have a balance of payments problem for the time being. If the Czech National Bank had not experienced a temporary drop in its reserves after the partition, the case could hardly have been made for a new stand-by arrangement. This chair is ready in a cooperative spirit to support the proposed decision, but the request is very close to the limits. The Czech request speaks, in my view, in favor of a very short-term financing facility in the Fund, which was alluded to during the Board retreat in February 1993.

A major concern the Czech Government has expressed is related to the need to preserve a high level of trade between the two Republics of Czechoslovakia. We feel that the creation of a payments agreement, with a clearing arrangement between the two central banks, is an appropriate measure to solve payments problems arising from the introduction of separate currencies in the two Republics. We wonder, however, what the chances are that the clearing system can survive even in the short run with the current clearing limit of ECU 130 million. Considering that estimates put the 1993 Slovak trade deficit vis-à-vis the Czech Republic at about ECU 230 million, this ceiling might prove to be too low rather quickly. Measures have been taken to bolster the Slovak Republic's trade balance and to secure the payments agreement, such as the recent devaluation of the Slovak currency and the revaluation of the Czech koruna. However, the causes of the trade imbalance between the two Republics cannot be eliminated by changing the price structure alone. The Slovak Republic will need to implement other measures to increase its competitiveness. This will take time, however, and imbalances are likely to persist in the medium run.

During the transition period, the least of all possible evils would probably be that the Czech Republic would accept a higher clearing limit in the context of the payments agreement with the Slovak Republic. It might be cheaper to raise this ceiling rather than to see the payments agreement crumble and, consequently, be faced with costs associated with an early switch to trading exclusively in convertible currencies.

I had a question concerning the problem of bad debts, which has already been answered, but it would be interesting to know more about the role of the Consolidation Bank. According to the staff, the Bank's job is to buy bad debts. In what way will the process of dealing with these bad debts be carried out, and how will the operations be financed?

Finally, I would like to ask a question about the Czech Republic's energy policy. As the Czechoslovak economy was oriented toward production that demands an intensive use of energy, the rational use of energy is a vital aspect of economic development in the Czech Republic. We would, therefore, be

> interested in the present state of affairs and in the progress that has been made in switching from brown coal to sources of energy that are less harmful to the environment.
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> I could not close my remarks without commending the Czech authorities for their remarkable performance in the transition process.

Mr. Dawson remarked that he disagreed with Mr. Kaeser that raising the clearing limit in the payments arrangement was the solution to the problem. Indeed, a number of Directors seemed to share the view that the problem had more to do with the exchange rate than the clearing limit itself. The payments arrangement should probably be viewed as transitional at best. In his view, raising the clearing limit would be a classic way of avoiding the necessary adjustment.

Mr. Al-Tuwaijri made the following statement:

> I am in broad agreement with the staff appraisal and have no difficulty in supporting the Czech authorities' request for a stand-by arrangement. The proposed stand-by arrangement would help support the continuation of adjustment and structural reform policies initiated under the stand-by arrangement with Czechoslovakia.
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> Performance under the latter arrangement was satisfactory, with significant success achieved in terms of the containment of inflation, fiscal consolidation, and the initiation of structural measures to facilitate private sector growth. Although Czech output declined in 1992, the 6.5 percent contraction of GDP looks quite modest in comparison with the dramatic declines observed in some other economies in transition. Moreover, there were encouraging signs of recovery in 1992, with strong growth of small enterprises in the private sector, a pickup in retail sales and construction activity, and even a modest upturn in the large state enterprise sector. External sector performance was broadly on track, although there was a sharp decline in reserves as a result of capital movements, which the authorities and the staff have linked to uncertainty over the dissolution of the federation.
>
> The relatively good performance under the arrangement with Czechoslovakia augurs well for the proposed arrangement. Most important, a large part of the immediate task of stabilization has been completed, and structural reforms initiated in recent years have begun to show results in terms of buoyant activity in the revitalized private sector and encouraging levels of direct investment. Difficult challenges remain, however. The Czech authorities must establish their credibility in terms of ensuring the containment of inflation through restrictive financial policies, a task that will be complicated by the VAT-induced price

jump and emerging wage-cost pressures. At the same time, the process of fiscal consolidation will have to be sustained, and further progress is needed in the areas of trade and exchange liberalization.

I would like to draw attention to two specific issues raised in the staff papers. First, I understand the authorities' concern about minimizing disruptions to trade following the dissolution of the federation, given the strong economic links between the two economies. In this context, the bilateral payments agreement with the Slovak Republic may well be the best immediate means of minimizing uncertainty and disruptions to trade and, therefore, may be consistent with the overall objectives of the program. I am concerned, however, that no time frame for the dismantling of these special arrangements is indicated in the staff paper, and I would be grateful if the staff could provide more information on this issue.

The authorities must firmly resist pressures to introduce a rigid system of wage indexation. The experience of other countries provides ample testimony about the dangers of generalized wage indexation, in terms of hampering the efficient operation of labor markets. Following the abolishment of wage controls in the state enterprise sector at the end of 1992, guidelines have been introduced that provide for wage increases of up to 15 percent, in line with the expected rate of inflation. There is also a provision for productivity-based increases of up to 5 percent, in addition to the full cost of living increase. Given the importance of the state enterprise sector as a lead sector in the determination of wage increases, could the staff comment on the implications of the current wage setting arrangements on labor costs and overall competitiveness?

Ms. Langdon made the following statement:

Despite a difficult domestic and external environment, economic developments in the Czech Republic in 1992 were generally in line with the program under the stand-by arrangement with Czechoslovakia. Much of the credit for this goes to the implementation by the Czech authorities of a rigorous macroeconomic stabilization program, appropriately supplemented by structural reforms. As the staff paper outlines, these measures are now beginning to show some encouraging results.

Looking ahead, however, there is no doubt that the Czech Republic faces some formidable challenges. Aside from the general uncertainty stemming from the dissolution of the federation, we also share many of the concerns expressed by previous speakers.

First, In light of my own country's experience with revenue shortfalls following the implementation of a goods and services tax, we were pleased to see that the authorities stand ready to take compensatory measures if revenues do not meet expectations. Perhaps the staff or Mr. de Groote could comment on what these measures could entail.

Second, given the uncertainties attached to the fiscal outlook and the risks associated with the recent sharp VAT-related increase in prices, it is essential that monetary and credit policies are kept sufficiently tight and consistent with the objective of restoring confidence in the Czech economy and maintaining external competitiveness. The importance of wage developments has become heightened, and the General Agreement between the Government, the trade unions, and employers referred to in Mr. de Groote's statement was most welcome. However, we would also appreciate comments from the staff on the appropriateness of the exchange rate arrangements, given recent developments, but particularly in relation to encouraging trade with the Slovak Republic.

This leads me to my final, and related, concern--the likely evolution of trade between the Czech and Slovak Republics. It is our understanding that the Slovak currency is already trading at a significant discount against the Czech koruna. This raises a number of questions. For example, to what extent are the two currencies convertible into each other, and to what extent has the payments and settlement system been affected by the breakup of the currency union. We hope that the these and other issues will be addressed in the context of the upcoming Article IV consultation.

Before concluding, my authorities would also like to have some clarification on the inflation figure reported in Reuters this morning indicating a monthly increase of 9.9 percent in February 1993. I realize that Reuters is not infallible, but a comment from the staff on this figure would be appreciated. I would also be interested to know from the staff when the Board could expect to discuss the Slovak Republic.

In concluding, based on the policies outlined by the authorities and their strong record of policy implementation, we support the request for a stand-by arrangement to strengthen foreign reserves. Provided that the authorities remain steadfast in their commitment to prudent stabilization and reform policies, while at the same time doing their utmost to limit trade disruptions with their former partner, there is every reason to believe that speculative outflows will cease and that international investors will show renewed confidence in the economy.

Mr. Mozhin made the following statement:

It looks as though the Czech Republic has every chance of becoming the most successful story of post-communist economic transformation, if not an economic textbook model of the optimal path from a nonmarket economy to a market one. From the very first moment of the Velvet Revolution, there has hardly been any wasted time in what seems to be an exceptionally smooth transition process. The perfect reputation of the Czech authorities, based on their past record of strict macroeconomic discipline, as well as creativity and decisiveness in the area of structural reform, has already become a separate factor in the future economic progress of the country.

At the same time, there are a number of problems that have to be resolved. Of course, the most serious one is related to the possibility of a significant disruption of trade between the Czech Republic and the Slovak Republic. The most recent developments in this area, as described in the statement by Mr. de Groote, are not very encouraging. With exports to the Slovak Republic accounting for about 12 percent of the Czech Republic's GDP in 1992, a significant disruption in trade could have a serious negative effect on growth prospects. I believe that this is not the only reason to question whether the growth projection of 1-3 percent for 1993 as a whole is overly optimistic.

The principal matter of concern here is the financial health of the enterprise sector, as well as of the banking sector. First, there have been a number of large-scale financial rescue operations in the past couple of years. Second, the implementation of bankruptcy legislation was postponed for more than six months, and the first bankruptcy of a major industrial company has yet to happen. Third, the level of unemployment remains suspiciously low, even if wage restraint over the past two years is taken into account. Fourth, despite remarkable achievements in the area of privatization, the share of the private sector is still less than 20 percent in terms of its contribution to GDP. All these developments seem to imply that the scope for further restructuring of the enterprise sector remains quite substantial.

However, I fully agree with Mr. de Groote that, whatever happens, it can only delay but not derail the expected recovery of the Czech economy. With this conclusion, I wish the Czech authorities well on their way to economic textbook-type success, and I support the proposed decision.

Mr. Hammoudi made the following statement:

At the outset, we would like to support the authorities' request for a stand-by arrangement, given the circumstances, the large reserves losses after the split of the federation, and the economic developments that occurred in 1992 in the Czech Republic.

Indeed, even if real GDP in the Czech Republic was lower than expected, there are signs that industrial production is picking up, construction activity is improving, and retail sales are rising. The monetary and credit results were in conformity with the program. Moreover, inflation has been in line with program targets, despite the introduction of the VAT and speculative increases in food prices. However, the balance of payments was in deficit, owing to reserves losses after the split of the federation and the underlying uncertainties. It is encouraging that capital flows have surged, owing to direct foreign investment and increased exports. We are pleased with the ongoing structural reforms, especially the privatization of the public enterprises.

Since we agree with the staff conclusions and support the authorities' policies, our comments will be brief.

Strict fiscal and monetary policies are needed to restore public confidence in the Government's policies. In this regard, we welcome the authorities' intention to balance the budget and to reduce the growth of monetary aggregates. The reforms introduced in the tax system, such as the VAT, and the income and social contribution system are important. On the expenditure side, we noted with satisfaction that the authorities are willing to take further actions if needed in order to attain the fiscal targets of the program. To this end, the elimination of wage indexation is an essential element for price stability, and, in this respect, we found very interesting the introduction of the wage guidelines in the budget law. Altogether, those policies could also improve the competitiveness of the Czech economy and boost exports.

Improving the external position of the Czech Republic requires the maintenance of a stable exchange rate, as stated by the staff and the authorities. Indeed, the exchange rate peg, in addition to the wage policy and strict monetary and fiscal policies, could improve the balance of payments situation if capital inflows and exports increased. This is already happening, as noted in Mr. de Groote's helpful statement. If external viability is to be strengthened, it is important that the authorities remain committed to further strengthen moves toward current account convertibility. Moreover, it is encouraging to note that cooperation is under way in the trade sector between the Slovak and Czech Republics. This could smooth the transition period and avoid disruption, as well as improve the balance of payments of both countries.

On the structural front, we are pleased to note the authorities' intention to pursue structural reforms in public enterprises and banks. For the banking sector reform to be successful, it is essential that privatization, consolidation of bank accounts, provisioning to offset bad loans, and recapitalization of banks all proceed in a coordinated and effective manner.

In conclusion, we are impressed by the authorities' decision not to purchase SDRs after the first tranche of the stand-by arrangement is drawn if the balance of payments situation improves. In this context, we are encouraged by the economic developments we are witnessing in 1993; however, the Fund should be flexible if the need arises. In fact, we commend the Fund staff for its quick response to the authorities' request for a stand-by arrangement.

Finally, we concur with the proposed decision.

The staff representative from the European I Department said that the Reuters report earlier in the day that monthly inflation had been 9.9 percent in February must have been a mistake. According to the most recent data, the consumer price index had, in fact, increased by only 1.3 percent in February.

The staff was not aware of any information that would suggest that there had been a significant reflow of capital to the Czech Republic since the separation of the Czech and Slovak currencies, the staff representative remarked. With respect to the appropriateness of the 1:1 conversion rate, the separation of the two countries had clearly imposed a significant cost on the Slovak Republic, largely because federal transfers to the Slovak budget had been discontinued; those transfers had been estimated at about 7-8 percent of the Slovak Republic's GDP. Therefore, there would have to be major policy adjustments in the Slovak Republic, and the whole range of policies was currently under discussion between the staff and the authorities. Clearly, however, the markets were expecting a substantial depreciation. Ever since the currency separation, the Slovak currency had been quoted at a discount for tourist purposes in the Czech Republic. Those expectations further increased the need for strong policy adjustments in the Slovak Republic.

The Slovak authorities had initially wanted a higher clearing limit under the payments agreement, while the Czech authorities had preferred a lower limit, the staff representative commented. The possibility of raising the limit was not precluded, however. In deciding whether to increase the limit, the Czech authorities would have to balance the extent of the damage to the Czech economy as a result of disruptions in supplies or in markets on the Slovak side against the cost to the Czech Republic of extending additional credit to the Slovak Republic and the impact that that would have on the creation of domestic liquidity and, therefore, the balance of payments of the Czech Republic. Clearly, difficult considerations would have to be balanced, but the existing clearing limit under the payments arrangement was expected to be reached fairly soon.

The Consolidation Bank, the staff representative remarked, was being financed from the proceeds of privatization for the purpose of cleaning up the books of commercial banks and extinguishing the bad debts of enterprises as part of the privatization process. It was generally agreed in other countries in Eastern Europe that the use of privatization proceeds to clean up the books of commercial banks was a very valid undertaking.

On energy policy, a major restructuring was being undertaken in the coal industry, and the price of brown coal had been liberalized, which had led to a reduction in demand, the staff representative said. The staff would certainly look into that issue more carefully at the time of the Article IV consultation.

With respect to wages, and labor costs more generally, the staff representative from the European I Department commented, the staff believed that the competitiveness of the economy could be maintained if wage increases were kept in line with the guidelines that had been set by the authorities. As he had mentioned in response to a question from Mr. Peretz, unit labor costs, adjusted for producer prices, were still about 12 percent below their level in 1990, and the evidence was that exports had performed quite well.

Mr. de Groote made the following concluding remarks:

> As evidenced by the solemnity and uniqueness of the most welcome introductory statement by the Chairman, this is, indeed, a great day for both the Czech Republic and the Fund. Each day in the Board, and each item on the agenda, carries its own climate. Today, the atmosphere in which we have examined the request before us has been one of legitimate satisfaction: satisfaction on the part of the Board for the rigorous implementation of its advice and for the supportive and rapid reaction of management; satisfaction on the part of the staff for the frankness of its dialogue with the Czech Government and the constructive outcome of the negotiations; and satisfaction on my own and Mr. Jonas's part for having been so closely associated with the success of a unique experiment in shock therapy, backed by policies that were at the same time audacious and prudent.
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> I see two main reasons for being confident. First, the leadership of the Czech Republic is largely made up of the same personalities who led Czechoslovakia in its progress to a market economy. Their readiness to act and their ability to implement their policies are well demonstrated. Mr. Mozhin has said that what they achieved was the setting into practice of a textbook

case. This is true, but only if we do not forget that this textbook case included the two preconditions for a nongradual approach to succeed: first, the absence of serious macroeconomic imbalances; and second, the existence of institutions, mechanisms, and autonomous enterprises needed for the liberalization of prices, foreign trade, and external payments to give meaning to the notion of competition.

At the time of the political changes, Czechoslovakia already enjoyed a high degree of management and accounting autonomy in a number of its large enterprises, and, by prudent monetary and budgetary policies, had avoided the accumulation of macroeconomic imbalances. During the period between the Velvet Revolution and January 1, 1991, when prices, trade, and payments were liberalized and economic planning eliminated, the Czechoslovak Government, unlike any other transition country government, reinforced the stance of budgetary and monetary management and introduced a critical mass of institutional reforms that could be regarded as sufficient to support the move to the market.

The second reason for confidence lies in the strength of the policies already being implemented--the public sector deficit will not exceed 1 percent of GDP. Wage guidelines will be implemented on the basis of an agreement among the social partners under supervision by the Government. Monetary policy is firmly in hand. A reflow of funds is taking place, and the country has recently demonstrated the continuity of its access to the international financial markets. Mr. Peretz has correctly characterized the arrangement that the Board is requested to approve today as a classic stand-by arrangement, aiming at assisting in the correction of a temporary balance of payments problem, not at supporting a country through a lengthy process of structural adjustment. The measures already being implemented should guarantee the rapid reversal of the situation and the capacity to repurchase the first credit tranche drawing before the end of the year or sooner.

My colleagues have expressed the view that success will depend mainly on two factors: effective wage policies and the preservation of favorable trade and payments relations with the Slovak Republic. On wages, answering the questions raised by Mr. Peretz and Mr. Schoenberg, I have to dispel the misunderstanding that abolishing the tax-based incomes policy would be a step in the direction of implicit wage indexation. The opposite is correct: it is a first step on the way to wage deregulation under government surveillance and toward an informal incomes policy that will show many similarities with that operating in Belgium. Social partners will monitor wage growth within limits determined by the expansion of output and the inflation rate, so that real wages will remain unchanged during the period of the program. For individual enterprises, wage negotiations will be based on each enterprise's economic performance. The movement of nominal wages will be submitted for government review on a quarterly basis for comparison with the same period of the previous year; the Government will introduce regulatory measures if actual wage increases in the previous quarter exceed the inflation rate, measured from the preceding 12 months, by more than 5 percent.

Relations with the Slovak Republic are the most important variable on which the program's success depends. I am confident that the ongoing process of negotiation with the Slovak Government will lead in the near future to a satisfactory agreement with the Fund. The media once more had it wrong when it stated that the negotiations between the Slovak Republic and the Fund were suspended. The fact is that the first Fund mission to Bratislava held discussions in a very positive climate of mutual understanding and then returned to Washington. It will be followed by one or more missions, as is normal in the continuous process of exchanging views that is needed to come to an agreement.

If it is possible today to conclude an agreement with the Czech Republic, while we still have to wait some time before a program for the Slovak Republic can be submitted, it is no doubt largely because the whole governmental apparatus of Czechoslovakia has been taken over by the Czech state, while the Slovak state has had to start from the ground up. The federal central bank, statistical office, tax administration, research departments, and ministries were all in Prague and stayed there. Mr. Dawson wonders whether the Slovak Republic's situation is not comparable in this respect to that of the republics of the former Soviet Union. Based on my experiences in Minsk and Alma Ata, this is not the case, because, at least in these two countries, a well-organized and competent framework of administration existed and has continued to function with the same personnel in the same locations.

Still on the issue of relations with the Slovak Republic, my colleagues asked about the sustainability of the clearing arrangements, and we witnessed an interesting exchange of views between Mr. Dawson and Mr. Kaeser on the appropriateness of enlarging the credit line under the clearing limits. While agreeing with Mr. Kaeser that the clearing arrangements have prevented a collapse of trade between the two countries, I share Mr. Dawson's view that increases in mutual credit facilities, more often than not, become an alibi for not adjusting the fundamental variables. By their very nature, clearing arrangements of the type existing between the Czech and Slovak Republics are temporary; they should be replaced as rapidly as possible by a system of full convertibility and freedom of payments. Miss Vori has mentioned the difficulty the Czech authorities were having in controlling monetary aggregates due to the inflows of funds from the Slovak Republic.

It is precisely this difficulty that explains the rigor of the monetary restraint being implemented by the Czech National Bank. Fortunately, these inflows have now slowed substantially.

As they do so well, my colleagues have given a wealth of good advice, which I will not fail to communicate to my authorities. Here, I will react to only a few of them. Mr. Shaalan and others have suggested that the authorities should rapidly identify the additional fiscal measures needed if the situation does not work out as well as we expect. Some of those measures are already identified, others are in preparation. I intend to transmit to the Board the full list of these measures once they have been completely worked out by the Government. Mr. Dawson recommended ending monopolies in the banking and financial sector. I very much support this suggestion and feel certain that my Czech authorities, who have a strong record for restoring market mechanisms, will establish competition in this area as soon this can be done realistically. Mr. Peretz hopes that the central bank will be as ready to lower reserve requirements when this becomes possible as it was to increase them when the crisis was building up. I can assure him that this is the clear intention of the Governor of the central bank.

Mr. Schoenberg offered some advice that may be directed as much to other industrial countries as to the Czech Republic: in essence, he is saying that "when a balance of payments crisis is building up and a country needs financial and moral support to overcome this temporary situation, come to the Fund for assistance. It is the Fund's role and duty to give it." My personal comment on this observation is that it was, perhaps paradoxically, the Czech Republic's good luck not to belong to a regional arrangement that allows balance of payments assistance to be obtained with little or no conditionality.

In ending, allow me to sound an optimistic warning: let us not underestimate the vigor of the market when institutions are in place permitting market impulses to express themselves in increases in supply, when enterprises have a sufficient degree of autonomy, and when macroeconomic conditions are correct. As all of these factors were present in Czechoslovakia, market incentives led the economy in rapidly switching over its foreign trade from East to West, absorbing the unemployment created by the labor shedding in unproductive entities that were transformed into fledgling private enterprises, stabilizing prices, and restoring output growth. The beneficial effect of the play of market forces should become even stronger once the first phase of privatization is completed and the privatized enterprises can start acting on their own. The share of total output that will be produced by the private sector will then be much higher than the 20 percent mentioned in the staff document, a figure referring to the situation before completion of the first phase of privatization.

The Executive Board then took the following decision:

1. The Czech Republic has requested a 12-month stand-by arrangement in an amount equivalent to SDR 177 million.

2. The Fund approves the stand-by arrangement set forth in EBS/93/27, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 10310-(93/35), adopted
March 17, 1993

3. TURKEY - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Turkey (SM/93/25, 1/28/93; and Cor. 1, 2/8/93). They also had before them a background paper on recent economic developments in Turkey (SM/93/32, 2/10/93; and Cor. 1, 2/17/93).

The staff representative from the European I Department said that the consumer price index had risen by 58.2 percent in February 1993 on a 12-month basis. Over the same period, wholesale prices in the private sector, which were the best available measure of underlying inflation, had risen by 62.6 percent, whereas the corresponding increase for wholesale prices in the public sector had been 49 percent--indicative of the fact that there had been some lag in public sector price adjustments recently. The 12-month rate of increase in industrial production had been 4.7 percent in January 1993, while manufacturing output had increased over the same period by 3.7 percent. Those increases were broadly consistent with the 4-5 percent forecast for economic growth in 1993. Finally, the budget deficit for January 1993 had increased by 163 percent over the deficit for January 1992, with expenditures and revenues having increased by 85.8 percent and 72 percent, respectively.

Mr. de Groote made the following statement:

Reaching an annual average of about 5 percent, the rate of growth of the Turkish economy in the 1980s and the beginning of the 1990s has been unequaled in the Western world. For 1993, the outlook is again for a GDP growth rate of a similar magnitude, which will be sustained, now that the recession is worsening in Turkey's main EC trading partners, mainly by a robust increase in private consumption. Private investment can be expected to play some part in the growth performance in 1993, since the uncertainties that stemmed from last year's delayed announcement of the new investment incentive regime have subsided. While the private consumption boom of 1992 was fueled by large increases in real wages and agricultural income, in a catching-up process after their almost continuous decline in the 1980s, the recent setting of a very tight nominal wage norm should, henceforth, prevent wage increases from automatically compensating for past inflation and frustrating policies aimed at reducing current inflation. Another favorable factor in the fight against inflation is that last year's financial market volatility, which led to speculative demand for foreign currency, has calmed. The Government recognizes, however, that neutralization of these two temporary factors that were responsible for the poor inflation performance in 1992 will not suffice to secure a lasting reduction in inflation, which in the end can be obtained only through a substantial fiscal adjustment.

A major fiscal adjustment effort was launched in 1992 by the Government that entered office in 1991 and that is having today its first Article IV consultation. The effectiveness of this effort is apparent from the fact that all fiscal deficit indicators peaked in 1991; they have been declining ever since. This decline could have been even faster except for the fact that the Turkish population, becoming more aware of western European models, expects the Government to continue playing an important role in both the economic and social spheres. As a result, the Government can do little more in the area of public expenditures than hold the line by stabilizing its ratio of expenditure to GDP.

On the revenue side, instead of resorting to annual measures to achieve their budgetary income targets, the authorities are now taking measures aimed at a durable improvement in tax revenues. Tax administration is one such improvement, and reform of the personal and corporate income tax system is another. The fiscal performance for 1993 will thus already benefit from the adoption of the Law on Acceleration of Tax Collection. The issue of extrabudgetary funds, about which the Board has consistently been critical, is also being dealt with: 62 of these funds have now been integrated into the consolidated budget. Under this new scheme, the income of these funds is counted under consolidated budget revenues, and a part of their expenditures is counted as budget appropriations. In addition, a centralized cash management system for controlling the revenue and expenditure of extrabudgetary funds has been implemented and is working efficiently.

Over time, the reforms already undertaken in the public enterprise sector can be expected to improve the fiscal position considerably. Revenues from privatization are already increasing, and the reform of the financial market should considerably speed the pace of the privatization process. The Capital Market Law was amended in May 1992 to secure transparency and confidence in the markets and to deepen the financial markets. This law will benefit the privatization process by streamlining and encouraging trade in securities.

In any event, the establishment of new structures and types of organization requires time in a country where the public enterprise sector is so firmly entrenched. Gradually responding to the structural reforms undertaken during the last two years, the private sector has already reacted very positively to the liberalization of financial markets and to the tariff reform. In addition, the reduction in the public sector borrowing requirement (PSBR) expected in 1993 will increase the amount of funds available for loans to the private sector. At the same time, the dissipation of uncertainties in the economy will improve the climate for private investment. A striking expression of the dynamism of the private sector is found in Turkey's massive involvement with the republics of the former Soviet Union. These activities will further diversify the basis of Turkey's current account position and add to its already considerable comparative advantage in trade with these republics, where its close cultural ties and the prestige derived from its economic achievements since the beginning of the 1980s within a framework of democratic institutions make it an example that the new nations of Central Asia may well wish to emulate.

Monetary policy for 1993 is not expected to differ substantially from that followed in 1992. The Central Bank will primarily control reserve money growth rather than other monetary aggregates in order to maintain stability in the foreign exchange market. Since there will be less pressure to finance public deficits, the Central Bank should have more freedom to keep its monetary policy in line with its medium-term objectives.

My Turkish authorities know that stable, sustainable growth can be achieved only in an environment of price stability. They are fully aware that further efforts are needed to consolidate the large gains of the past and extend them into the medium term. They recognize that fiscal policy is the key to reducing the economy's vulnerability to external shocks and improving the country's balance of payments position. While recognizing that adjustment requires constant retuning to meet changing circumstances, they remain committed to privatization, which has achieved good results so far, and they continue to work with the World Bank on the reform of public enterprises and the organization of the social safety net that needs to accompany the privatization process. As liberalization in other areas must be supported by a dynamic financial sector, the authorities will move forward with the reform of this sector to obtain greater efficiency and better mobilization of savings. In the newly opened financial sector, only 3 of the 52 commercial banks are owned by the public sector, and 18 of them are foreign owned. These steps in the direction of a more effective market economy must be combined, in the authorities' view, with policies aimed at a better distribution of income.

Mr. Mirakhor made the following statement:

The excellent staff papers and Mr. de Groote's helpful statement provide a comprehensive picture of economic developments in Turkey in the past year; a picture that continues to be one of contrast. On the one hand, the authorities' determined pursuit of a wide-ranging program of structural reforms has shown many signs of success, and much has been achieved. Output and investment growth have, on average, been high, fueled by a dynamic and increasingly outward-oriented private sector. The major liberalization of the trade and exchange system carried out in the past few years has been an important factor contributing to the resilience of the external accounts in the face of adverse external shocks. Export growth has shown considerable strength, while the capital account has been bolstered by large infusions of foreign direct investment in manufacturing and services. The exchange rate has been managed in a satisfactory manner.

On the other hand, these impressive accomplishments have been marred by weaknesses in domestic economic management. Fiscal-induced demand pressures, aggravated by developments on the cost side, have placed a heavy strain on resources. As a consequence, inflation has shown substantial momentum. The weakness of public finances--and the associated pressures for monetary accommodation--derive essentially from underlying structural problems, namely, the financial and economic performance of the state economic enterprises and the relatively low yield of the tax system.

The new Government has shown its awareness of the potentially adverse implications of a continuation of these imbalances and of the importance of refocusing policy on controlling the momentum of domestic demand while strengthening the supply side of the economy. The central elements in its program for 1993 are the adoption of a budgetary stance that aims to bring the PSBR down to 9.5 percent of GNP and a return to restrictive quantitative monetary targets. While the staff has some misgivings about the achievability of the authorities' fiscal program, we believe that it represents a commendable first step toward placing Turkey back on a path of sustained growth. The budget contains some notable features. The reintegration of extrabudgetary funds into the budget is a bold step; and wages are being tightly compressed although, as the staff notes, it would be important for the authorities to exercise a strong leadership role and to stand firm against pressures for yielding to wage demands in excess of the budget. It is true that progress in other areas has been less vigorous than one would have hoped. Nevertheless, a promising start has been made in formulating a major reform of the corporate and personal income tax system and in building a consensus in support of privatization and public enterprise reform. These are elements that can be expected to yield considerable efficiency gains in the years ahead.

A key question in this year's consultation is how the set of policies that have been put in place in 1993 can be extended over the medium term with greater specificity as to the scope and timing of fiscal adjustment. I believe that a medium-term plan broadly along the lines suggested by the staff in its fiscal adjustment scenario is a path of adjustment that the authorities might wish to consider carefully. In the past, the Turkish authorities have not hesitated to undertake bold adjustments; historically, in fact, Turkey was among the earlier adjustors. It was on the frontiers of financial liberalization in the early 1980s, and so far it has gained so much ground in structural adjustment that, according to press reports, "the World Bank considers Turkey to be at the mature end of structural adjustment."

This is all the more reason why the authorities should be urged to undertake the needed fiscal adjustment to reduce inflation substantially. The Turkish economy, with a strong and resilient private sector, an enviably strong reserves position, and a diversified export structure with a bright future, has an excellent opportunity to undertake the needed fiscal adjustment in order to reduce the very real risks of an erosion of the gains it has made over the last decade and a half. Particularly alarming is the stark conclusion of the staff's excellent analysis of fiscal sustainability in an inflationary environment, set out in Appendix I to the background paper on recent economic developments, that the elimination of public sector imbalances is a prerequisite for durable and credible disinflation, and that further fiscal adjustment is needed to offset continued currency substitution and financial innovation in order to prevent inflation from rising. In this context, and given that inflation, although high, seems to be stable, I wonder whether the staff would care to hazard a guess at how inflation might behave if the substantial fiscal adjustment is not forthcoming. It also appears that Mr. de Groote's reading of the 1992 fiscal adjustment and its impact is at variance with that of the staff. I wonder whether Mr. de Groote or the staff would care to comment on this point.

Be that as it may, an objective of eliminating the primary imbalance of the public sector over a period of three years would have a number of favorable effects, most notably, on inflationary expectations, nominal wage performance, and private sector confidence. Although the domestic demand impact of fiscal adjustment is expected to lead to a weakening of economic activity--a fact that is of understandable concern to the authorities--the growth of real GNP will exceed that in the slippage scenario by 1995, and both inflation performance and the current account path would be more favorable. While choosing a more gradual path of adjustment might seem to be a more attractive alternative, the fragility of Turkey's macroeconomic situation would suggest that it could risk deeper problems.

The staff has addressed the question of the consistency of monetary and fiscal policies, on the one hand, and wage decisions, on the other hand. There appears to be an emerging consensus among the authorities and the social partners on the desirability of an understanding of wage and price objectives that are in line with a target path of decelerating inflation. I wonder whether consideration has been given to developing more concrete policies in this regard. Would a formal incomes policy be suited to Turkey's sociopolitical context? Perhaps Mr. de Groote or the staff could give us some information on this subject, and indicate whether such a proposal should await a track record of fiscal adjustment and lower inflation or be implemented up-front so as to reinforce the process of disinflation.

Finally, a comment about Turkey's exchange rate policy. The authorities deserve to be commended for the manner in which they have managed the exchange rate and for having recouped much of the earlier loss in competitiveness. The staff supports this flexible approach, arguing that it has insulated the external sector from the pressures emanating from the weaknesses in the domestic economy. However, given the continued volatility of monetary aggregates, and in the absence of any formal incomes policy, the economy would appear to have no anchor to serve as a discipline for the domestic price level. Indeed, it could be argued that the flexibility of the exchange rate has tended to keep inflation high by validating wage and price increases at rates above those consistent with a lower inflationary path. There is an important issue of timing here, that is, whether one should wait until the disinflation process has gathered momentum before shifting to a more stable exchange system or whether, in the fight against inflation, all elements of economic policy should be allowed to play their respective roles.

Mr. Al-Jasser made the following statement:

The Turkish authorities' sustained implementation of economic liberalization measures has invigorated economic activity and fostered an environment that proved conducive to export-led growth in output and investment. Indeed, as Mr. de Groote indicates in his statement, output performance in 1993 is expected to register robust growth, despite the worsening recession in Turkey's main EC trade partners.

Although the authorities have generally pursued market-oriented policies, they have been unable to implement successfully, and in a timely manner, a program of privatization and public enterprise reform. As a result, the state enterprise sector continues to represent a significant drain on public resources. This persistent drain, together with the difficulty in controlling the multitude of extrabudgetary funds, as well as their acquiescence to generous wage demands, has led to the emergence of substantial fiscal deficits. More seriously, the monetization of these deficits has aggravated inflationary pressures and entrenched inflationary expectations. However, the authorities have been able to insulate the external sector from the very accommodating macroeconomic domestic stance through the adoption of a flexible exchange rate policy. While this exchange rate policy has obvious shortcomings, especially as it tends to contribute to inflationary pressures, it has nevertheless succeeded in preserving export growth and external competitiveness.

The well-written staff report clearly highlights the main challenge confronting the Turkish economy, namely, large fiscal deficits that have led to escalating inflationary pressures. Moreover, the inflationary effects of fiscal deficits have been further exacerbated by the emergence of large and increasing currency substitution. As a result--and as well explained by Mr. Calvo and Mr. Végh in their interesting working papers on this issue--the monetary base of the inflation tax is being eroded, which, in turn, necessitates a higher inflation tax than in the absence of currency substitution. Indeed, for a given real fiscal deficit, the presence of currency substitution aggravates the resulting inflation rate. Consequently, greater fiscal consolidation becomes ever more urgent so as to break this vicious circle.

Therefore, I fully endorse the staff recommendation for resolute efforts to address Turkey's fiscal problem. While I welcome the authorities' recognition of the urgent need for fiscal consolidation and their intention to reduce the PSBR to 9.5 percent of GNP in 1993, I share the staff concerns regarding the likelihood of attaining these objectives. This is underscored by the difficulties the authorities continue to have in controlling the extrabudgetary funds, despite the very welcome centralization of their major operations. Furthermore, the announced revenue increases appear to be insufficient to achieve the desired results, while public sector spending is expected to increase. In this context, it is imperative for the authorities to maintain a tight rein on wages, given their crucial role in the formation of inflationary expectations, as well as their large share in budgetary outlays.

Consequently, I echo the staff's call in urging the authorities to adopt a multiyear deficit-reduction package that focuses on public sector rationalization, as well as revenue enhancements and spending restraints. In this context, the specific staff proposals are highly pertinent. Such a package should enhance credibility and sufficiently alter expectations to initiate the process of disinflation. Indeed, once the authorities' commitment to disinflation is perceived to be credible, then currency substitution would begin to reverse, thereby reducing the inflation tax necessary to finance a given deficit. Naturally, further reductions in the fiscal deficit would accelerate the decline in inflation.

While the authorities are putting together a credible fiscal consolidation package, deficit financing and debt management should continue to command the authorities' close attention. Two alternative strategies can be identified: first, the authorities could try to contain the inflationary effects of budget deficits by moving toward a nominal exchange rate target and financing the deficit through domestic debt creation; and second, the authorities could continue to monetize the deficit and maintain a flexible exchange rate policy. As the interesting appendix in the background paper indicates, bond financing would initially contain monetary growth, yet would eventually markedly increase interest payments and place the debt ratio on an explosive path. An ever-escalating domestic debt burden would markedly affect expectations and intensify currency substitution, while the nominal exchange rate target would adversely affect external competition, thereby risking a deterioration in output performance.

Hence, the authorities appear to be pursuing the appropriate strategy of monetizing the deficit, maintaining a flexible exchange rate, and refraining from implementing a monetary program. While this strategy has obvious drawbacks, it seems to have successfully shielded the productive export sector from the negative effects of price instability. Moreover, although this strategy complicates monetary targeting, I agree with the authorities that without demonstrable and durable progress on the fiscal front, it is inappropriate to move toward a nominal exchange rate target. However, once such progress is realized, an argument can be made in support of moving toward a nominal exchange rate target, as it could enhance the credibility of the disinflation strategy, thereby unleashing a virtuous circle of deficit reduction, "dedollarization," and disinflation. Moreover, the adoption of the exchange rate as a nominal anchor in the context of a credible deficit-reduction package could help protect external competitiveness by ensuring that the value of the domestic currency does not overshoot.

Mr. Desruelle made the following statement:

The performance of Turkey's economy in 1992 was marked by a strong rebound in output. GDP grew at an annual rate of 5.4 percent, fueled by both domestic consumption and exports. The performance of exports was particularly remarkable. After a strong expansion throughout the 1980s and the early 1990s, exports increased again last year by more than 10 percent in real terms; thus, the share of exports of goods and services in GNP rose to more than 21 percent in 1992.

Other positive developments include a continued strong level of private savings. As a result, the current account deficit was limited to 1.1 percent of GDP, even though the public sector incurred fairly large net dissavings, and, as the staff report rightly notes, "Turkey had no difficulty in financing its external credit needs." In this respect, one can also note the continued importance of foreign direct investment in Turkey.

On the other side of the picture, inflation and the PSBR remained high, even though both decreased slightly.

Given this situation, I will make a few remarks about the unusual macroeconomic combination of high growth and high inflation, the risks of an acceleration of inflation, and measures to decrease the PSBR.

As I said, both inflation and growth were high in 1992. This unusual combination is not a new development for Turkey; in the past six years, GNP grew on average at an annual rate of 4.6 percent, while the inflation rate averaged 64 percent. This strong growth performance has been attributed in large part to the trade liberalization program Turkey undertook at the beginning of the 1980s. Such a view is supported by the fact that, during the same six-year period, exports grew at an annual rate of 11.8 percent, more than twice as fast as GNP.

One may wonder about the extent to which large changes in nominal terms have so far had a significant impact on real output volatility. In the specific case of Turkey, the relatively weak performance of GNP growth experienced during two years of the present high inflation period may reasonably be attributed in large part to real factors: in 1989, adverse climatic conditions led to a fall in agricultural production of more than 2 percent of GDP; and in 1991, Turkey was affected by external developments beyond its control.

Nevertheless, a persistently high level of inflation is worrisome. A situation of high but fairly constant inflation and high growth might ultimately be unstable. Even though this combination can last for quite a number of years, it usually ends up either in a dramatic increase in inflation or in a marked decrease in the growth performance.

In this regard, two recent developments in Turkey are noteworthy. First, the duration of collective bargaining agreements has tended to shorten, and wage indexation has become more prevalent in these agreements. The development of wage indexation, and of price indexation in general, can limit distortions in relative prices in the short term and, therefore, the real effects of inflation. However, as has been shown in other countries, it also increases the inertial component of inflation, and makes inflation very resilient to efforts to eradicate it. Second, foreign currency deposits of residents continue to grow significantly faster than domestic currency deposits. The persistence of inflation and the increased use of foreign currency could erode the inflation tax base and reduce the seignorage at any given level of inflation. Therefore--and here I refer to the very interesting appendix in the background paper--if the fiscal deficit is financed at the margin by money creation, a constant deficit would entail a rising inflation level.

The PSBR decreased in 1992 by 3.4 percent of GNP. Nevertheless, it did not decrease as much as was expected under the authorities' program, and it remains very high at 13.4 percent of GNP. Therefore, the PSBR has to be reduced further. The authorities' plan to bring down the PSBR by 3.8 percent of GNP in 1993 is welcome. I note that most of this fiscal adjustment should come from further centralization of the operations of extrabudgetary funds, improvements in tax collection, and increased privatization receipts. I also agree with the staff that it would be extremely helpful to design a medium-term plan for fiscal consolidation measures. This would enhance the credibility of the authorities' fiscal efforts and bring down the inflationary expectations of private economic agents.

On this fiscal issue, three points deserve, in my view, to be underlined. First, broadening the tax base has to be an essential part of any fiscal plan. Total tax revenues of the general government represent only 25 percent of GNP, which is, by any standard, very low. Furthermore, even though tax rates are not particularly low, the personal income tax and VAT yield to the consolidated budget only 7.8 percent and 5.3 percent of GNP, respectively. I would welcome staff comments on this point.

Second, privatization of state economic enterprises may not be a panacea for fiscal consolidation. It is noteworthy that, in 1992, eight such enterprises accounted for 92 percent of the PSBR of all state enterprises, and that among these eight enterprises, three were involved in agricultural price support and three others were public utilities. Therefore, the issue of borrowing requirements of state economic enterprises has two very distinct aspects. The first is the need for reform of agricultural price support, possibly in the direction of better targeting of support to the agricultural sector. The second deals with the financing needs of public utilities. It may very well be that, given the need for infrastructure investment, and irrespective of reforms in the regulatory environment, the borrowing requirements of public utilities will remain important in the near future.

Third, given the recent rise in real wages in both the public sector and large firms, an incomes policy may have a role to play in a comprehensive program of fiscal consolidation.

In conclusion, I wish to reiterate the support of my authorities for the program of trade and financial liberalization that the Turkish authorities have been successfully implementing since the early 1980s, and to express the hope that the impressive gains made in the past decade will be buttressed by appropriate macroeconomic measures.

Mr. Schoenberg made the following statement:

In retrospect, it appears that the conditions for a significant adjustment effort in Turkey were reasonably good in 1992: growth was recovering strongly, the balance of payments position had stabilized, access to international capital markets was being retained, and a new Government could be expected to be less influenced by concerns about "election economics." While the authorities have made some efforts to tackle the severe imbalances characterizing the Turkish economy, it appears that these efforts fell far short of what is required to bring the Turkish economy to a stable path of noninflationary growth, and that even the authorities' own targets, which were not overly ambitious anyway, were missed by a substantive margin. In the areas where some progress was made in 1992, it has been the result, to a large extent, of temporary measures, like the reduction in stockbuilding by public enterprises. In many respects, therefore, 1992 could be called a lost year in the authorities' struggle for a lasting improvement in Turkey's economic fundamentals. The main reason for the somewhat disappointing performance, as we see it, has been the continued unevenness of policy implementation.

The staff report gives an excellent review of the pressing problems the Turkish economy is facing, and I fully endorse its policy recommendations. As the staff has stated, high inflation continues to be the most serious economic problem in Turkey, and I support the emphasis that is given to the urgent need for forceful steps in reducing inflationary pressures if the Turkish economy is not to suffer lasting damages. An inflation rate of almost 70 percent is not only extremely out of line with other OECD countries, but is also, ultimately, not conducive to enhancing the prospects of any Euro-ambitions Turkey might nurse. The key to a successful reduction in the rate of inflation, of course, lies in a more determined approach to drastically reducing the chronic imbalances in the fiscal sector, including the extrabudgetary funds, and the financial position of the state enterprise sector.

The staff calls, in particular, for a more ambitious program of fiscal consolidation within a medium-term program, including substantial up-front adjustment, and--like Mr. Al-Jasser--I would like to support these recommendations. A convincing medium-term consolidation program could go a long way toward reducing the uncertainties that characterize the future course of financial policies in Turkey and could have a stabilizing effect on expectations. Such a medium-term program would also provide a better understanding of the size of the fiscal problem and the resulting adjustment needs. Lastly, such an approach might help to avoid the need for the authorities to rely excessively on temporary measures, which would only delay the burden of adjustment for another year. For example, it does not help much to correct the underlying fiscal imbalance if, as reported on page 13 of the background paper, an improvement in the fiscal position results from the fact that a "lengthening of the average maturity structure...would shift the bulk of interest payments on new debt to 1993."

It goes without saying that the huge imbalances that have accumulated in Turkey call for a fundamental and visible reorientation of economic policy. This reorientation of economic policy should also include measures to discontinue the widespread indexation of wages and a renewed effort to come to grips with the problems of state enterprises, which continue to constitute a heavy burden on public resources. Presumably, such a policy approach could be reinforced by an exchange rate policy that would aim more at supporting internal stabilization targets instead of accommodating actual price and cost developments. A policy aimed at a more stable nominal exchange rate, if supported by adequate domestic adjustment measures, could signal the change in the policy regime more clearly to the private sector and help to break the inflationary expectations that seem to characterize the Turkish economy.

Incidentally, a lasting reduction in inflation would, in itself, help to improve the fiscal position, since it would reduce the burden of interest payments. This should serve as a further incentive for the authorities to proceed more vigorously on the path to fiscal consolidation.

I take it from the staff report that many elements of the expected improvements on the revenue side anticipated by the Turkish authorities for this year are based on very optimistic assumptions, and that no major intrusions into public spending are foreseen. This view is confirmed by Mr. de Groote's statement, which says that "the Government can do little more in the area of public expenditures than hold the line by stabilizing its ratio of expenditure to GDP." In addition, the staff raises doubts about the authorities' ability to contain the wage bill within the limits set by the budget, and I concur with the staff that the authorities should stay firm in this regard. Given that personnel expenditure accounts for 40 percent of spending and has doubled in terms of GDP over the past four years, I wonder whether the authorities should not aim at more than keeping the wage bill constant in terms of GDP.

Turning to monetary policy, I have only a few points to add. The conduct of monetary policy can certainly not be separated from the stance of fiscal policy, and its effectiveness is hampered by the renewed reliance of the authorities on central bank financing. I refer to what has been said by Mr. Mirakhor and the French chair in this regard. The increasing dollarization of the economy does not seem to make the conduct of monetary policy easier. In this context, I found it interesting to note that, according to Table A30 in the background paper, real interest rates on deposits seem to have been negative for most maturities--a phenomenon that, if continued, could contribute to a further increase in currency substitution and lead to substantial capital flight. It is, therefore, important that the authorities refrain from attempting to control interest rates, with the objective of reducing the burden on the budget.

I should also like to urge the authorities to take further measures to improve the functioning of financial markets and, in particular, to reduce the inappropriately high spreads between lending and deposit rates in the banking sector, including by possibly eliminating the transactions tax.

A further strengthening of monetary instruments also seems warranted. It is somewhat astonishing to note from a staff report for a relatively highly developed economy like Turkey that the monetary authorities' ability to influence the growth of monetary aggregates is being aggravated by a lack of marketable securities, and that the Central Bank had to take recourse to the sale of foreign exchange to reduce the impact of central bank financing of the public sector deficit on the growth of monetary aggregates. The effects of foreign exchange sales on monetary conditions appear to be rather limited anyway in the presence of a high degree of currency substitution, and a substantial reduction of reserves could have negative effects on Turkey's creditworthiness, which the country is endeavoring to retain.

Extending his remarks, Mr. Schoenberg said that Mr. de Groote's observation that Turkey's growth was unequaled in the Western world should be balanced by the fact that it also had a strong population growth rate of more than 2 percent a year.

Mr. de Groote remarked that Mr. Schoenberg seemed to imply that, as a general proposition, population growth was a cause of income growth.

Mr. Schoenberg commented that, in absolute terms, population growth was, indeed, a cause of income growth.

Mr. Abbott made the following statement:

I would like to compliment the staff on an excellent report on the Article IV consultation with Turkey. The analysis is crisp, incisive, coherent, and economically sophisticated. The write-ups of both the staff report and the background paper are models of clarity and succinctness. In this regard, I would like to agree with Mr. Mirakhor about the way in which the background material was woven into the subjects discussed in the staff report.

In his statement, Mr. de Groote emphasizes the strong economic performance of Turkey during the 1980s, and he interprets the results of 1992, when growth recovered to over 5 percent after the dislocations of 1991, as a return to an established pattern of systematic economic progress in Turkey. The staff, on the other hand, states that the "quality of the recovery has been unsatisfactory." High and rising inflation, coupled with piecemeal and unconvincing attempts to correct an unsustainable large fiscal deficit, are the central elements in what the staff sees as an unsatisfactory recovery. The private sector has been performing rather well, but its continuing prosperity is at risk from poorly disciplined public finances. We found the staff analysis to be highly persuasive.

Recent developments in Turkey fit all too well into a familiar model of how countries frequently get into trouble trying to sustain growth in the face of persistently high inflation and large PSBRs. Past inflation provides a rationalization for catch-up wage and price adjustments in the noncompetitive public sector. Financing requirements of the public sector and nervous inflation expectations put upward pressure on interest rates. Financial market tensions prompt the government to look to the central bank for temporary accommodation, with the justification that market tensions are only seasonal and the PSBR is on the verge of falling. Consequent monetary expansion gives inflation an upward twist. External transactions payments turn adverse. Interest rates are adjusted, but the financing requirements of the public sector feel the backwash, and the uneasy cycle continues, possibly at a higher plateau of inflation, and usually with disruptions to private sector prosperity.

All these elements, plus a few more, are present in contemporary Turkey. Inflation seems to have ratcheted up from a 40 percent range in the 1980s to an unstable plateau well above 60 percent in the last couple of years. The public sector deficit is well above 10 percent of GDP. Breaking out of this cycle requires decisive correction of the fiscal problem, but, on present trends, such a correction looks problematic.

One of the more interesting features of the staff analysis is its systematic assessment of the size and volatility of the inflation tax in Turkey. Even treating the calculations as only rough estimates, it looks like the implicit tax generated through inflation has generated revenues for the Government in excess of 4 percent of GDP. Since total consolidated budget revenues are about 25 percent of GDP, the inflation tax is a significant component of government revenue. On standard analysis, the inflation tax has some Laffer curve properties, so that further increases in inflation cannot be counted on to provide additional inflation tax revenue. In fact, there is some risk that, with inflation already quite high, a further increase in inflation might, on its own, undermine attempts to establish control over the fiscal imbalance.

A complicating feature in Turkey is that financial liberalization, which has made very good progress, undermines collection of the inflation tax. The process by which the money multiplier expands and the monetary base shrinks relative to the aggregates is well explained in the staff papers. A further wrinkle in Turkey is dollarization, whereby residents have a fairly easy option of protecting themselves from the inflation tax by switching out of domestic deposits and into foreign currency deposits.

The message of the staff analysis is that the mix of rising inflation and financial liberalization has added an additional degree of instability to Turkey's financial situation. The possibility of a breakout to much higher rates of inflation has been accentuated. The urgency of correcting the underlying fiscal imbalance has increased. Like Mr. Mirakhor, I would be interested in any additional comments the staff has on the stability of the inflation process.

For all the reasons identified by the staff, we are skeptical about the soundness of the authorities' strategy for curtailing the fiscal deficit. Expected tax collections, wage restraint, and interest payments all seem to be estimated optimistically. More important, the Government's plans do not address the major spending rigidities in the consolidated budget, nor do they face up to the problems of the inefficiency of the large public enterprise sector.

With regard to public enterprises, we would urge the authorities to implement a restructuring plan along the lines proposed by the World Bank. This would involve divestiture and liquidation of enterprises, regulation of natural monopolies, retirement of excess labor, and explicit budgetary allocations for noncommercial services performed by state economic enterprises.

We fully agree with the staff advice that the Turkish authorities "need to change from a year-by-year approach to fiscal adjustment to a well-articulated medium-term plan in which the scope and pace of adjustment are clearly delineated and buttressed by specific initiatives." We also agree that preparing such a plan should be given as much priority in 1993 as achieving the short-term fiscal target for this year. The excellent analysis in this year's Article IV consultation report provides a good starting point for developing such a medium-term plan.

Good financial management requires proper accounting. In this regard, we would hope that by the next review it would be possible to report that progress had been made in quantifying the total volume of defense spending.

Regarding the exchange rate regime, I can agree with one aspect of other speakers' comments. That is, I can agree that alteration of the exchange regime is a subject that can wait for discussion until Turkey is well established on a credible fiscal consolidation path and on a viable disinflation path. My own view is that it is unhelpful, at this stage, to even raise the issue of a switchover in exchange arrangements. As I read the staff analysis, the uncertain stability of financial arrangements in Turkey makes either bond financing or monetary financing of government deficits risky strategies in the current inflationary environment. Either option could lead to explosive outcomes. The dynamic paths may be different, but neither option is attractive. A different exchange regime would not correct this basic instability. In light of this, it seems to me that introducing the issue of alternative exchange rate regimes merely distracts attention from the central issue of getting the public sector deficit under control.

The staff representative from the European I Department said that the main risk for the stability of inflation was that the base of the inflation tax would be eroded further as a result of the continuation of currency substitution. The extent of currency substitution, of course, depended very much on confidence, which, in turn, was related to the authorities' willingness to tackle the fiscal problem. For the previous four or five years, the rate of inflation had hovered around the 60 percent level, with a range of 50-70 percent.

As it was difficult to judge how long that situation could be sustained, the staff representative remarked, the staff had avoided the generation of "doomsday scenarios," in which dramatic consequences were predicted to occur after a certain period of time. In its discussions with the authorities, however, the staff had argued that there were a number of factors that went in the direction of suggesting that the situation was getting more unstable. The key element in that argument was the erosion of the base of the inflation tax through increased currency substitution. Another element was the recent change in the arrangements for indexing wages, in which the review period for backward-looking wage indexation had been reduced from one year, to six months, to three months. That change did not, in itself, lead to higher inflation, but it did have the effect of perpetuating inflation once it began to increase.

All Directors had indicated the importance of an adjustment in the PSBR in bringing inflation down, the staff representative recalled. It was far from clear, however, particularly in light of the experience in 1992 and the dynamics of the inflation tax, that a reduction in the PSBR would be sufficient to reduce inflation, which suggested that other policies were needed to support the inflation objective. The authorities and the social partners agreed that incomes policy had a role to play, but incomes policy in Turkey did not have a well-defined meaning. As it was currently being discussed in Turkey, an incomes policy would comprise an understanding between the Government and the social partners that inflation was on a downward path, and that the price decisions of industry and the wage-bargaining process should incorporate a path for inflation along the lines of that projected by the Government. In its discussions with the social partners, the staff had been given the impression that there was a great deal of mistrust among the social partners, which would tend to hinder the effectiveness of an incomes policy, even with the best intentions.

Some Directors had stated that the exchange rate could play a role as a nominal anchor, but only if there were indications that the fiscal adjustment was well under way, the staff representative noted. The staff had taken the view that it would be unwise to use the exchange rate at the beginning of the disinflation process in Turkey. The exchange rate had protected the external sector very well, and those benefits should not be given up until it was clear that the fiscal adjustment had begun to take root. Once that adjustment had been put in place, the Government might begin to consider whether the exchange rate could be used as a nominal anchor. Until then, however, it was important to maintain the viability of the external sector.

On the need to broaden the tax base, the authorities had proposed a tax reform that went very much in that direction on both the corporate side and the private side, to which the staff had given its qualified support, the staff representative from the European I Department said. The authorities' reform proposal was being discussed in Parliament, but not all of its elements were coming through unscathed. In particular, with regard to the proposals on corporate income taxation, some very good proposals were being watered down. One of the most worrisome aspects of the process was that the Government had only recently pushed through Parliament a far-reaching law on investment incentives, which had not been contemplated when the tax reform proposals had been put on the table. Consequently, the authorities estimated that investment incentives under the new law would cost the Government on the order LT 22 trillion in 1993, while the budget for incentives provided for only about LT 2.5 trillion in 1993. It remained to be seen how that inconsistency would be resolved during the year.

Mr. Shaalan made the following statement:

> Macroeconomic developments in Turkey over the past few years have been characterized by growing fiscal imbalances, along with monetary accommodation and the absence of wage moderation. In 1992, there was only a limited improvement in the budgetary outcome, and wage pressures intensified, bringing about an acceleration of inflation.
>
> It should, therefore, come as no surprise that we concur that there is a need to initiate a drastic disinflation process, including, above all, a sharp cutback in the deficit financing of the public sector. But we would also be inclined to give some role to the exchange rate, if the authorities' overriding objective is to reduce the rate of inflation. The current real exchange rate rule adopted by the authorities can lead to an effective loss of a nominal anchor for the economy, as the inflation rate tends to be automatically accommodated. Furthermore, in some instances, the rule can contribute to the inertia--by indexing the exchange rate to past inflation--that seems to characterize the inflation process in Turkey.
>
> Given these observations, we would appreciate the views of the staff on the appropriateness of the authorities' current exchange rate arrangement and exchange rate policy. Specifically, with the resilience of the external current account and the high priority to bring inflation down, is it not desirable to manage the floating exchange rate so as to bring greater stability to the

nominal rate and, thereby, help dampen expectations? Obviously, such a policy change would also have a drawback, namely, the possible loss of external competitiveness if appropriate financial policies are not put in place, but it is difficult to see how a durable reduction in inflation is possible under the current exchange rate rule.

On fiscal policy, the risks of further delay in adjustment appear to be mounting. First, rapid foreign currency substitution, and financial innovation more generally, have increased the inflationary effects of monetary financing of the public sector deficit. On this basis, some fiscal adjustment is needed simply to prevent inflation from rising. Second, the high cost of servicing government debt has led to pressures to circumvent the payment of market interest rates through recourse to unsustainable monetary financing and official interference with interest rates. Further fiscal slippages would reinforce these pressures, with adverse effects on external short-term capital movements. Therefore, the adjustments envisaged in the 1993 budget must be supplemented by other measures to make for a credible fiscal policy; these measures should include public sector wage restraint, a reduction in agricultural support prices, and reform of large loss-making state enterprises.

Mr. Havrylyshyn made the following statement:

The Turkish economy's excellent performance, underlying strength, and growth potential are unquestioned. This is reflected in the relatively high rates of growth, averaging about 7 percent a year in the mid-1980s, and in the growth attained in 1990 and 1992. The economy is also characterized by a fairly well-balanced distribution of productive sectors, as shown by the contribution to GDP of agriculture, the variety of manufacturing activity, and the services sector, particularly tourism.

Turkey has managed to open its economy and integrate it into the world economy well, and its potential is clearly shown by the strength of export growth, which in five out of the last eight years has exceeded import growth in volume terms. The inherent dynamism of its exports is illustrated by the surge in trade with countries of the former Soviet Union, and my authorities in Ukraine look forward to a much greater share of Turkish trade than the 3.3 percent indicated in the background paper on recent economic developments. In recent years, Turkey has also developed and deepened its financial sector and reduced its ratios of debt to GNP and debt service relative to the mid- and late 1980s. This external record has been rewarded with increased access to international capital markets.

Given all this, it is disappointing, to say the least, to see the deteriorating situation in three areas of macroeconomic balances. The already unacceptably high inflation rate has accelerated to about 66 percent in the last three years, compared with about 43 percent in the period 1985-87. There has been a sharp increase in the PSBR, averaging about 13.9 percent of GNP in 1990-92, compared with its average yearly level of 6.6 percent of GNP in the mid- and late 1980s. One also observes the return in the 1990s to external current account deficits, even if these are still being maintained at the low level of about 1 percent of GNP.

It is evident from the staff report that the major culprit in this deterioration, has been the inability of the authorities to control the fiscal deficit, particularly as a result of laxity in dealing with the excessive income and wage increases. Indeed, personnel expenditures in the consolidated budget, which stood at about 24 percent of total expenditure in 1988, had risen to about 40 percent by 1992. Similarly, such expenditures as a percent of GNP, when added to those of local government and state economic enterprises, rose from 8.9 percent to 21 percent over the same period.

Given these developments, the need for a strong and, especially, specific incomes policy to limit wage and income increases is imperative and needs to be formulated and implemented as a matter of urgency. The staff's strong recommendation for the authorities to "stand firm in this area" is insufficient, if the underlying fiscal problem is, indeed, to be tackled effectively. In this respect, I note the point made by Mr. de Groote in his informative statement that a very tight nominal wage norm has recently been set by the authorities; this, of course, is what is needed. Could Mr. de Groote or the staff amplify a little on this norm as regards the limits set and the practical ways it is being applied?

An important adjunct to any policy dealing with reducing fiscal deficits in Turkey must be, as the staff notes, the acceleration of the pace of privatization and divestiture of the public sector enterprises, particularly those in the areas where private sector activity is best suited. In addition, the restructuring toward economic efficiency of the larger public utilities will be crucial. It should not escape our notice that about a third of the public sector requirement arises from the state economic enterprises. In the meantime, and until momentum is built up on privatization, I would urge the authorities to push for the immediate passing of the proposed law that would enable state-owned enterprises to work on a commercial basis, without political interference.

Finally on the fiscal side, while I appreciate the difficulties with respect to the treatment of the Defence Support Fund, its size is such that I feel it should also be brought into the budget as soon as possible.

The staff seems to feel that the retention of a flexible exchange rate policy is appropriate; however, one wonders whether, for the future, one should consider the possibility of a shift to a strategy of a fixed exchange rate. I appreciate the fact that a flexible exchange rate has helped protect the external position of the economy, despite the fiscal deterioration. The trade-off is between maintaining a good external position, on the one hand, and, on the other hand, the accommodation of inflationary developments, taking pressure off the authorities to implement unpalatable but necessary domestic policies. In any event, if more appropriate monetary and fiscal policies bear more of the adjustment burden, this in itself would lead to improvements in the external account. In this respect, I wonder whether the reference in Mr. de Groote's statement to "maintaining stability in the foreign exchange market" and to the authorities' recognition "that fiscal policy is the key to reducing the economy's vulnerability to external shocks" are an indication of this shift in policy.

In conclusion, Turkey can be characterized as an impressive case of adjustment and opening up during the 1980s, based on sensible exchange rate and foreign trade operations. While fiscal and monetary policies were somewhat loose, although adequate, throughout this period, this discipline has continued to deteriorate and has worsened sharply since 1990, which threatens to undermine the earlier achievements. It is clear that exchange rate adjustments alone will be far from sufficient to correct imbalances, and the primary policy strategy must be to institute much better fiscal and monetary control.

Mr. Schoenberg said that he fully supported the comments of the staff and Mr. Havrylyshyn on the exchange rate issue. For the sake of clarity, he would note that he had neither advocated a fixed exchange rate regime for Turkey nor commented on the priority to be given to a change in the exchange rate regime relative to other policy changes. In his view, the issue was whether the exchange rate could be used in some way as a "dragging" anchor, which would lag behind actual developments in inflation and, thereby, exercise a supplementary restraining force on inflationary developments.

Mr. Abbott remarked that the situation in Turkey was very similar to that in many countries in Latin America over the previous 20 years. Indeed, Latin America was littered with cases in which the authorities had attempted, with great expectations, to rely on an exchange rate anchor, only to fail for lack of the necessary supporting fiscal discipline. For that reason, it would probably be better to put the issue aside for the moment and not suggest to the Turkish authorities that they should give it their active consideration. The staff had struck the right balance in saying that the authorities should divide their time equally between working on a medium-term strategy and resolving the fiscal problems for 1993. In the same vein, the Fund should offer the authorities some advice on the amount of time that they should devote to exchange rate issues: they should not even begin to consider those issues for three or four years, or at least not until they had been able to digest better the recent experience of other countries with that approach to policy.

Mr. Torres made the following statement:

The economic results in Turkey in 1992 have been mixed. On the one hand, real GNP growth was high and export volumes increased considerably. On the other hand, the inflation rate has increased substantially, the fiscal deficit remains high, and monetary policy has been, to some extent, out of control.

The main problem underlying the macroeconomic disequilibrium seems to be the growing fiscal deficit and the Government's practice of financing the deficit through monetary expansion. As a result of this approach to deficit financing, the public sector has imposed a considerable burden on monetary policy. To finance this deficit, the monetary aggregates have had to expand well in excess of those defined in the monetary program, fueling inflation and undermining the credibility of the monetary authorities. In this regard, I fully agree with the monetary authorities on their decision not to announce publicly a monetary program for 1993, given the uncertainties surrounding the fiscal program for this year.

As is shown in the background paper on recent economic developments, it is extremely costly to attempt artificial interest rate reductions as a way of lowering the burden of the fiscal deficit. Such attempts have resulted in continued inflation, international reserves loses, and diminished confidence. As is also clearly expressed in the staff report, the fiscal deficit is caused by a combination of structural and temporary factors.

Turning to structural factors, it seems to me that the most urgent of all reforms is privatization. The public enterprises were responsible for about 30 percent of the total PSBR in 1991, which amounted to nearly 17 percent of GNP. This figure was reduced in 1992 but, even so, continued to be very high. A strong privatization program would serve not only the purpose of reducing the fiscal deficit but also of gaining confidence about the Government's intention to achieve fiscal consolidation. In this regard, we agree with the staff report on the need to define a medium-term fiscal program, in which specific initiatives and goals are clearly defined. Such a program should be complemented by a commitment from the authorities to respect pre-established limits on monetary financing of the public sector. I am afraid that if corrective measures in this area are not taken very soon, the inertial character that inflation has acquired will become too strong, to the point where indexation clauses will become a common feature in all wage settlements.

On exchange rate policy, I agree with the authorities that, before considering the use of a nominal exchange rate target as a way of having a price anchor, there has to be fiscal consolidation, which is not the case now. Meanwhile, it would be more appropriate to maintain the present flexible exchange rate system to allow the real exchange rate to remain stable.

In conclusion, it seems to me that, to the benefit of the Turkish economy, its problems are concentrated in one very well-defined area: the fiscal equilibrium. In this regard, the authorities have to be commended for the improvements they have made recently, and, at the same time, they have to be encouraged to go further and faster with some of the most important and urgently needed structural reforms, such as the restructuring and privatization of public enterprises.

Mr. Fridriksson remarked that Iceland's inflation performance used to be very much associated with that of Turkey; indeed, Turkey and Iceland had commonly been referred to together in footnotes in OECD tables on price performance because of their very high inflation rates. The exchange rate in Iceland used to perform the same function as it did currently in Turkey--namely, securing the external balance and providing a vehicle through which the economy could react quickly to external shocks. After some progress in fiscal consolidation, Iceland had decided to fix the exchange rate in late 1989, and it had pursued a fixed exchange rate policy since then, ultimately topping the list of strong price performers in the OECD in 1992. Therefore, he very strongly endorsed the comments of Mr. Havrylyshyn on exchange rate policy.

Mr. Abbott asked whether Mr. Fridriksson would like to comment on the experience of other members of his constituency with fixed exchange rates.

Mr. Fridriksson noted that, among the members of his constituency, Turkey's situation was comparable only to that of Iceland.

Mr. Wei made the following statement:

We agree with the thrust of the staff appraisal and share the views expressed in Mr. de Groote's very helpful statement, as well as most of the comments made by previous speakers. My intervention will, therefore, be brief.

The problem of continued high inflation and its root cause, the unduly expansionary fiscal policy, were the focus of concern at the Board discussion on the 1991 Article IV consultation with Turkey. They are of no less concern today. Inflation is even higher now than it was two years ago, reflecting a lack of effective adjustment of the public sector imbalance. The level of the PSBR, although falling from its peak of 16.8 percent of GNP in 1991, remains higher than that in 1990. Such an inflationary environment is clearly preventing the economy from achieving sustainable growth and therefore calls for a firm commitment on the part of the authorities to undertake credible fiscal adjustment without delay.

A substantial tightening of fiscal policy through both revenue and expenditure measures is urgently needed to address the present problem. In this regard, the centralization of the operations of the extrabudgetary funds is a welcome development, both in terms of revenue enhancement and the expenditure-restraint effect. Further efforts are needed, though, to obtain full control over their operations. Other revenue measures have also been proposed, some of which, however, do not seem fully convincing. Furthermore, despite the uncertainty about some of the revenue proposals, we note with concern that the fiscal adjustment proposed for 1993 falls almost entirely on the revenue side, and that spending will not be cut but will, instead, be increased in terms of GNP.

Under these circumstances, it is crucial that every effort be made to realize to the fullest extent possible the revenue gains proposed and to control spending firmly. With regard to the latter, containing personnel spending is of crucial importance in order to avoid overspending, especially at the central government level, considering the heavy weight of personnel costs in budgetary outlays and the experience of past slippages.

Looking beyond 1993, it is apparent that a significant turnaround in the fiscal situation hinges on an improved tax system, combined with a medium-term strategy to reduce imbalances. Therefore, we join the staff in urging the authorities to move in this direction.

On the monetary front, an immediate task is to restore the monetary policy credibility that has been undermined by fiscal slippages and that has adversely affected inflation expectations. While correcting the public sector imbalance is essential for monetary policy credibility, measures are needed to achieve more effective monetary management and reduce the main constraints on the central bank in carrying out useful market intervention. Regarding the latter, recent capital market reforms are particularly welcome, because they open up greater opportunities to securitize government debt.

Finally, while commending the authorities for the progress made in liberalizing the domestic financial and trade systems, I would like to stress again the importance of establishing as soon as possible a medium-term strategy to correct the fiscal imbalance and to embark on a disinflation process.

Mr. Cippa made the following statement:

The Turkish economy presents a hybrid picture of success and failure and of unfinished economic adjustment. On the one hand, it shows an impressive performance, particularly with regard to overall economic growth, exports--including services and remittances--and foreign investment. Recovery after the 1991 slump that was due to the Middle East crisis has been quick, thus demonstrating the Turkish economy's ability to respond promptly to external shocks. Clearly, this responsiveness relates directly to the adjustment that these sectors have undergone in the past, resulting, inter alia, in an open foreign trade regime and a flexible exchange rate policy.

On the other hand, however, the domestic economy still seems to be in need of additional adjustment efforts, with a consistently high, unsustainable fiscal deficit that is largely financed by monetary means, and the resulting high inflation rates.

Although interest rates are kept at positive levels in real terms, there are signs of eroding confidence in the present stance of Turkish policy. While hesitating to tackle the fiscal problem of accumulating debt and growing debt service, as well as the monetary problem of constantly fueling inflation by financing a large part of this deficit, the Government's credibility is increasingly questioned by inflation-conscious domestic economic actors.

The staff report puts forward a clear argument for a stronger fiscal and monetary policy stance that commits the Government to undertake, in the short term, courageous measures to curtail public spending, including defense, as well as to work toward monetary restraint and moderate wage settlements to curb inflation. Furthermore, a longer-term structural reform of the public sector, including tax reform and restructuring and privatization of state enterprises, is needed.

We would encourage the Turkish Government to extend its reform efforts, which have proved so effective on the external side, to the domestic economy as well, in order to liberate the economy's full potential of dynamism and creativity.

The Executive Directors agreed to continue the discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/34 (3/12/93) and EBM/93/35 (3/17/93).

4. CZECH REPUBLIC - REPRESENTATIVE RATE FOR KORUNA AS CURRENCY OF THE CZECH REPUBLIC

The Fund finds, after consultation with the authorities of the Czech Republic, that the representative exchange rate for the Czech koruna under Rule O-2(b)(i) is the midpoint between spot buying and selling rates for the U.S. dollar as determined and quoted by the Czech National Bank. (EBD/93/41, 3/11/93)

Decision No. 10311-(93/35) G/S, adopted
March 15, 1993

5. OMAN - 1992 INTERIM ARTICLE IV CONSULTATION

The Fund notes the staff report for the 1992 interim Article IV consultation with Oman (SM/93/49, 3/2/93) and declares the consultation completed.

Decision No. 10312-(93/35), adopted
March 16, 1993

6. PERU - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 10143-(92/119), adopted September 16, 1992, shall be amended by substituting "no later than March 18, 1993" for "within six months." (EBS/93/38, 3/11/93)

Decision No. 10313-(93/35), adopted
March 15, 1993

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/79 through 92/86 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/93/47 (3/12/93) is approved.

APPROVED: November 1, 1993

LEO VAN HOUTVEN
Secretary